



## CASE NOTE: FAMILY COMPANY DERIVATIVE FEUD

Adrian C.K. Wong

12.04.2023



In Hong Kong, families often hold properties and businesses through corporate vehicles, with family members also being shareholders and directors of the company. This creates a particular set of problems when those members take an informal approach to the management of company affairs. If family relationships take a turn for the worst, such informality may be exploited as a means to seek intended derivative action by the minority, alleging a breach of fiduciary duty, which occurred in [Re: Woncorn Investment Limited \[2022\] HKCFI 1680](#). The question thus arises: how relevant is the familial context when a family feud coincides with company derivative actions?

In this case, a mother and her five children held shares in a company. The company held a property which the mother paid for, that she and the unmarried children lived in since 1986. The flat had been used as the company business address, for holding board and general meetings, booked as non-current assets, with the company paying the relevant utilities, repairs, rent and rates.

When the mother died, her shares in the company were split equally amongst the five siblings. One of the sisters emigrated and transferred all her shares to another sister, so the remaining brothers and sisters held shares in a 2:3 proportion. The elder brother and two sisters were directors of the company, whilst the younger brother and one of the sisters continued to occupy the property, rent-free. But disagreements started to arise shortly after the mother's passing. The brothers (in the 40% minority) wished for the flat to be sold and proceeds distributed as dividends. The sisters (in the 60% majority) wished to allow the unmarried siblings to continue living in the flat. At both the board and general meeting levels, the proposal by the brothers for the flat to be sold was voted down. Litigation ensued, with the brothers seeking leave for

statutory derivative action by the company against the sisters under s.733 of the Companies Ordinance (Cap. 622). The allegation was that the sisters, by refusing to vacate, rent out or sell the flat, and occupying it rent-free, were in breach of their fiduciary duties, acting in conflict of interest with the company.

There was apparent attraction for the brothers to apply for leave for derivative action. The bar is low: it only requires a serious issue to be tried and that the company has not itself brought the proceedings; and that the application appears to be in the interest of the company (which is usually *prima facie* satisfied where a serious question to be tried is demonstrated). Plus, under s. 738(2),(3) of the Companies Ordinance, the court may order indemnification by the company of the member's costs in applying for leave and/or bringing the derivative action, provided such member was acting in good faith and had reasonable grounds for bringing the proceedings/application. In essence, the brothers could be able to use the company's assets to fund their attack, whilst the sisters fund their own defence. This causes a great disadvantage and pressure to the majority in terms of litigation and negotiation.

In this case, the court carefully considered the familial context of the case and dismissed the brothers' application for leave. Whilst it is true that fiduciaries are not allowed to put themselves in a position where their interest conflict with their duties, it was clarified that directors of a company do not necessarily have a duty to procure sale of a company property. The flat was classified in the financial statements as "non-current assets". The brothers admitted that the company was an asset-holding family company vehicle without any business for profit. There were no inherent duties on the sisters to procure sale of properties, so it cannot be said that they conflicted with such duty.

Crucially, there was incontrovertible evidence (drawing from the background and history of the flat, pictures of its interior use and various company documents) that the company consented to the siblings living in the flat prior to the mother's death. The principle from *In re Duomatic* [1969] 2 Ch 365 comes into play: a director's act otherwise in breach of their fiduciary duty to the company is not such a breach if the shareholders, with full knowledge, have agreed to it, either expressly or tacitly. This is particularly relevant in a family company context. Whilst family members may not have formally or clearly resolved how to deal with company, given the relationship, it would be difficult for a disgruntled member to deny knowledge of what has occurred within the family over a long period of time (in this case, 34 years). As in *Sharma v Sharma* [2014] B.C.C. 73, that meetings amongst family members (who were also shareholders) were relatively informal did not stop the application of *In re Duomatic*. The Court can and did find agreement by shareholders via their knowledge of the directors' act and acquiescence thereof.

The brothers also invoked the wrong procedure in seeking leave for derivative action. Their complaint was not so much an issue of director misconduct as a mismanagement complaint amongst shareholders. The sisters, as majority shareholders, voted against the selling of the flat whilst the brothers sought distribution of dividends amongst shareholders after the sale. As such, derivative action against the sisters in their capacity as directors simply would not redress the complaint.

This case demonstrates why starting a derivative action against family company directors warrants additional scrutiny. Whilst the bar for leave is low, and having the company indemnify one's legal costs is enticing, the family context will become relevant both in terms of the nature of the company, the duty of the directors

and the ways in which the court may find consent by members to the complained act. Nonetheless, amicable relationships can change quickly in the absence of parents. As such, it is always prudent to keep proper company records and minutes to safeguard a position.

[Adrian CK Wong](#) acted for the company in this action. The CFI's judgement can be accessed [here](#).