

## Perfect storm of class action litigation, greater regulations may hit Hong Kong institutions, say lawyers

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Recent proposals to permit class action lawsuits and tougher securities liability rules in Hong Kong could possibly spell greater lawsuits against the territory's banking and financial institutions, said a local lawyer. Gareth Hughes, a partner with law firm Ashurst, told Thomson Reuters that while allowing group lawsuits was long awaited and welcome, institutions should be concerned.

"The threat of class action suits coupled with increased scrutiny and regulations from the Securities and Futures Commission (SFC) could create a perfect storm in terms of litigation against financial institutions," said Hughes. He said that should such a regime extend to beyond consumer disputes, it could have a significant but indirect impact on compliance managers and in-house counsel at financial firms.

The Law Reform Commission of Hong Kong (LRC) recommended legislation on Monday to permit groups with common grievances to sue through a sole representative. The body issued a report containing its proposals for reform.

The territory currently allows multi-party proceedings, but under rules that have been criticised as inadequate and restrictive. Under local law, losing parties pay all or part of their opponent's legal fees — thereby deterring individual investors seeking damages. The proposed new system would only cover consumer fraud and product liability in cases involving goods, services, and immovable property or real estate — but not investments such as securities, the LRC said earlier this week.

"Company directors will not face a class action for a fraudulent prospectus. At least not for a few years until they get around to broadening the scope of the law," said David Webb, a local shareholder rights activist.

However, purchasers of financial products sold by retail banks and brokerages would be allowed to seek permission to sue as a class under such a system in future, Anthony Neoh, chairman of the LRC's sub-committee on the class action proposal, told local media earlier this week.

"A distinction appears to have been drawn between consumer cases and securities cases, including mis-selling and negligent investment advice, which occupy a significant part of any institution's risk portfolio," said Keith Brandt, managing partner of Hong Kong law firm Brandt, Chan & Partners in Hong Kong, an SNR Denton affiliate. "If that distinction is maintained and the commission's recommendation is adopted, institutions should have the luxury of time in observing and monitoring developments."

Compliance officers and in-house lawyers at institutions needed to familiarise themselves with class action procedures, Brandt said. They also needed to revamp their risk management systems to identify, manage and settle any risk of group litigation early on, he added.

“They also need to revisit their insurance arrangements, in particular directors’ and officers’ liability insurance, in light of potentially wider litigation exposure and consequently greater financial liability. It goes without saying that the potentially wider financial liability entails the need to step up on corporate governance and internal control,” said Brandt.

A further commission proposal is that for the first five years, only cases before the High Court would be eligible for class action.

Litigation risks for the institutions in the territory, particularly those selling securities, have been relatively low so far, said Jeffrey Maddox, a partner with law firm Cadwalader, Wickersham & Taft in Hong Kong.

### **Judicial economy**

In November 2009, the LRC’s class action sub-committee recommended allowing such lawsuits after losses by over 30,000 local investors in credit-linked notes guaranteed by failed investment bank Lehman Brothers. The investors later alleged mis-selling of structured products. Consultations on class actions ended in 2010.

“Banking and financial institutions already have stringent controls in place and would have since the Lehman minibond mis-selling matter improved on those controls,” said Brandt.

He added that compliance officers and in-house counsel should instead embrace a class action regime to better manage institutional risk and exposure, given its ability to potentially bind all claimants and resolve all claims in one action.

Chris Dobby, a partner with law firm Hogan Lovells in Hong Kong, told Thomson Reuters that group litigation offered judicial economy. “There should be one set of precedents for cases raising common questions. Class actions are a powerful tool giving a certified, constituted group of aggrieved customers a ready, organised platform to file suit,” he said. He said defendants benefited from solving their problems all at once, “rather than dealing with seemingly endless lawsuits brought by individuals”.

The need for class actions “most typically arises where a large number of persons have been adversely affected by another’s conduct, but each person’s loss is too small” to make individual litigation feasible, the commission said on Monday. The LRC’s final recommendation came two weeks after the SFC proposed extending criminal and civil liability laws for IPO sponsors that signed off on inaccurate or misleading prospectuses. The SFC said tighter laws were needed to protect investors after finding substandard work by many investment banks arranging IPOs.

Ashurst's Hughes said allowing class actions could spur better management and corporate governance at the city's

publicly listed companies.

“The recommendations ... represent a further piece in the jigsaw of the authorities wanting to present Hong Kong as a leading financial centre,” he said. Such a regime would ensure that market participants were accountable for their actions, he added.

## **Funding**

A source close to the LRC sub-committee, speaking on condition of anonymity, said funding was the primary obstacle to class actions. “Hong Kong has no contingency fees. How do you get a class action lawsuit running without them?” he said.

Class actions would be funded by the Consumer Council’s Consumer Legal Action Fund, with a general government fund suggested for when other types of group suits were allowed. Contingency fees and other forms of conditional litigation funding were not recommended by the LRC.

“Instead the LRC proposes the Consumer Council have a monopoly on funding class actions, beefing up the legal aid fund which takes up to 50 percent of the winnings,” David Webb said, adding it was a huge disappointment and that Hong Kong deserved better.

The 18-year fund has helped 681 out of 1,231 applicants since its establishment. Yet, Cadwalader’s Maddox suggested that greater funding was needed. “Maybe that means a levy on share trading, but a budget of \$2 million (HK15.52 million) isn’t enough to litigate complex financial cases. There’s no real teeth,” he said.

## **Timing**

Neoh, a former chairman of the SFC, told local press that the government needed to take action on the proposals. He declined, however, to comment on if or when the regime could be expanded to shareholders of publicly-listed companies.

The source close to the sub-committee said “people would have to understand the rules and not abuse them”, noting that the process of implementing the reforms could take five to 10 years. “The mood amongst the sub-committee is cautious and concerned. But I am prepared to endorse the [LRC’s] recommendations because they are quite limited,” he said.

Similarly, John Hickin, a partner with law firm Mayer Brown JSM in Hong Kong, said the limited scope of the recommendations showed a general lack of enthusiasm. “The current initiative is a step in the direction of class action lawsuits, but they won’t come any time soon,” he told Thomson Reuters.

Class actions have been a long-running local legal reform issue, ever since the LRC appointed a working party on the matter in 2000. But the LRC tends to move slowly.

“People on the [sub-]committee have busy professional lives and so the process doesn’t move that quickly. There’s nothing special about the timing. But perhaps, with a new [government] coming in, they [the LRC] thought there might be some appetite for change there,” said Hickin.

With consultations on the reform closing more than two years ago, Webb said the LRC’s conclusions were long overdue. “A better question is why they took so long?” he asked.

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