Propositions of Crowdfunding Regime in Hong Kong – Part II

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Crowdfunding opens the door for start-ups to aggregate capital from a large number of investors without meeting tough financing requirements from traditional financial institutions like banks.

Meanwhile, given the low survival rate of start-ups, protective measures for investors against potential losses are of paramount importance. Similar to the concept of crowdfunding, a class action regime may provide a viable solution for investors with inadequate resources to join together to effectively assert their claims.

The available recourse in multi-party actions is limited in Hong Kong. At present, the sole machinery in which such a kind action can be brought is under Order 15, rule 12 of the Rules of the High Court (Cap 4A). It requires all members of the class to show identical issues of fact and law in representative proceedings.

On the other hand, western common law jurisdictions like the U.S., UK, Australia and Canada have long introduced class action regimes.

Introducing a class action regime has been under discussion for years in Hong Kong. Solicitor General of the Hong Kong government Wesley Wong said in a 2016 interview that ushering in class action regime will be a far-reaching reform to the legal system.

Starry Start-up's Fall from Grace

A starry start-up' spectacular fall from grace illustrates how class action regime could help a large number of investors recover losses in crowdfunding founded in 2003, a blood-test laboratory. It was once boasted as a Wall Street darling. It touted its ground-breaking technologies being able to perform blood test from just a pinprick. After rounds of financing, Theranos' peaked at a valuation of USD 9 billion in 2014.

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The disaster stroke after a series of Wall Street Journal reports suggesting the technologies were flawed and inaccurate. Forbes magazine reported in mid-2016 that Theranos' value had diminished to USD 800 million. Theranos is now facing several class actions for breach of contract, false advertising and consumer fraud, among other claims.

Opt-out Approach

Last year, a British court ushered in U.S. style class action, with the Consumer Rights Act 2015 coming into force; lying at the heart is the introduction of "opt out" actions where every affected party is automatically included as a member of the "class" of claimants.

Previously, when groups of consumers or small and medium-sized businesses (SMEs) in the UK wanted to take action, they either had to "opt in" to the action or bring a claim in their own names.

But with the adoption of opt-out approach, every affected party will be automatically “opted in” the claim, unless they opt “out”, or exclude themselves from the class of claimants. There will be strength in numbers and claimants could get their money back without lifting a finger.

Canadian courts have also adopted the opt-out mechanism. In a recent case Locking v. McCowan, all persons or entities who held units of Partners Real Estate Investment Trustor or resided therein as of April 1, 2014, are automatically included as plaintiffs or class members. If the class action is successful, the participating class members may be entitled to share the amount of award or settlement recovered. A class member who opts out in this case will not be entitled to participate in the class action and will not be entitled to share in the amount of any award or settlement.

Costs and Damages

A core benefit of bringing class action lawsuit is that costs to litigate the claims will be spread across many plaintiffs, so it is more feasible for them to be able to afford to litigate the case. Class actions in jurisdictions like the U.S. are handled on a contingent fee basis, meaning that the plaintiffs do not pay for legal fees unless they win the case.

With much lower litigation costs, it would be much easier for the aggrieved investors who took part in crowdfunding to seek justice against misbehaved companies.

‘Exemplary' damages are the settled principle of the U.S. common law, with an aim of deterring people from engaging misconducts.

For the case in the UK, the fact that the losing side is typically required to pay the winner's costs acts as a deterrent to frivolous claims, and there are no treble or exemplary damages. That means damages awarded are compensatory and not windfalls for claimants. This principle would also limit the unmanageability of the losing defendant.

Incremental Adoption

The Law Reform Commission (LRC) of Hong Kong issued a report in 2012 on proposals of class action regime. The LRC noted that a class action regime should be introduced first in the Court of First Instance and its extension to the District Court should be deferred for five years until sufficient experience is accumulated through the establishment of a body of case laws on the new procedures.

The opt-out approach was also mentioned in the LRC report: once the court certifies that a case is suitable for a class action, members of the class, as defined in the court order, would be automatically bound by the class action, unless they “opt out” of the class action within the time limits prescribed by the court order.

Flaws do exist in the opt-out approach, but in a comparative study of the LRC covering the major class action systems in a number of jurisdictions, it was found that the degree of participation under opt-in systems was lower than that found under opt-out systems.

The LRC further advised an incremental approach, to start applying class action regime to consumer cases only, so that the court system can gain experience in this new type of procedure, before assessing whether and when the regime should be extended to other types of cases.

Restoration Orders

For corporate finance cases, section 213 (2)(b) of the Securities and Futures Ordinance (SFO) (hereafter S. 213) may have the effects of a "de facto" class action.

Under S. 213, where a person has contravened a provision of the SFO, the court can make orders requiring a person to take steps as directed by the court, including restoring the parties to a transaction to the position they were in before the transaction was entered into.

SFC commenced a proceeding in 2007 against Du Jun, a former managing director of Morgan Stanley Asia Limited who engaged in insider dealing in shares of CITIC Resources Holdings Limited in 2007. In 2013, the Court of First Instance held Du liable, ordering him to pay about HKD 23.9 million as a result of his insider dealing. The SFC notified CITIC Resources, Morgan Stanley Asia Limited and all 297 investors of the orders and unless there is any valid objection, pursuant to S.213.

The payment to be made by Du represented the differences between the actual price at which the affected investors sold the CITIC Resources shares to Du and the price at which the investors could have sold the shares had the price sensitive information concerning CITIC Resources been made known to the market at the time as assessed by expert. Du was also ordered to pay the SFC's legal costs and the fees of the court appointed administrators.

In another landmark case, Tiger Asia Management LLC (Tiger Asia) and two of its senior officers were ordered to pay HKD 45,266,610 to investors affected by their insider dealing involving two Hong Kong-listed banking stocks. By deploying S. 213, 1,800 innocent investors were put back closely to the positions they were in before the transactions took place.

S. 213 and Crowdfunding

S.213 of the SFO is important ammunition for the regulators to demand compensation for a large number of investors, as illustrated for instance in Du Jun and Tiger Asia cases. As suggested in part one, a range of crowdfunding activities may fall under three types of traditional activities: providing automated trading services (Type 7), dealing in securities (Type 1), or advising on corporate finance (Type 6), as defined by the SFO, in order to get crowdfunding activities regulated and establish valid claims.

The legislature might consider making amendments to S.213 and include opt-out provisions. Once the court holds a regulated crowdfunding platform or a start-up liable for misconducts in the course of crowdfunding, in an appropriate case the SFC may make an application under S.213 and seek remedies to restore financial positions for class members, who had been automatically "opted in" the class. They should be entitled to share the damages if they win the case, as long as they can prove that they did make investment in the defendant's start-up during a certain period of time.

The opt-out mechanism can avoid the situation that some class members may not want to be bound by a suit that they did not start but is proceeding to settlement or judgment against their own will. For those investors who stay with the class action, they can pursue a more expeditious path of litigation with fewer legal costs incurred.

The court or regulators have to overcome a series of technical limitations, such as setting a reasonable deadline for opting out, and making sure all class members are notified and able to exercise their rights to opt out.

The "in" class members should closely follow the progress of the litigation, to make sure they receive their shares of damages, even though they did not have to take any action to opt in.

As Hong Kong legal workers are generally short of experiences in dealing with class action lawsuits, the Hong Kong Bar Association or the Law Society of Hong Kong may work with overseas counterparts to organize relevant training courses for lawyers.

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While the momentum of introducing class action regime is gathering in Hong Kong, the government and legislature have to consider how to balance the need to promote access to justice, and how to bar unmeritorious claims which might create a "litigious culture".

Pros and Cons of Opt-out Approach

Pros

(a) defendants are unlikely to have to deal with any claims other than those made in the class action, and if they do, then they can know more precisely how many class members they may face in subsequent individual proceedings;

(b) the opt-out regime enhances access to legal remedies for those who are disadvantaged either socially, intellectually or psychologically and who would be unable for one reason or another to take the positive step of including themselves in the proceedings;

(c) increased efficiency and the avoidance of multiplicity of proceedings to the benefit of all concerned;

(d) access to justice is the basic rationale for class actions, and inclusiveness in the class should be promoted (ie, the vulnerable should be swept in);

(e) safeguards can prevent "roping in" (eg, adequate notice explaining opt-out rights, permission to opt out late in the action, and other procedural requirements);

(f) for each class member, the goal of individual choice whether or not to pursue a remedy can be achieved if the decision for the class member is whether to continue proceedings rather than commence them;

(g) opting out more effectively ensures that defendants are assessed for the full measure of the damages they have caused rather than escaping that consequence simply because a number of class members do not take steps to opt in.

Cons

(a) it is objectionable that a person can pursue an action on behalf of others without an express mandate;

(b) a person is required to take a positive step to disassociate from litigation which he/she has done little or nothing to promote;

(c) class actions may be raised by busy-bodies, encouraged by unprincipled entrepreneurial lawyers;

(d) absent class members may know about the litigation too late to opt out, in which case they are bound by the result, whether or not they want to be;

(e) unfairness to defendants is increased by creating an unmanageably large group in which the members are not identified by name and it is very difficult to undertake negotiations for a settlement;

(f) it is unattractive for a court to enforce claims against the defending party at the instance of plaintiffs who are entirely passive and may have no desire to prosecute the claim;

(g) opt-out regimes create potential for the general res judicata effect of the class action judgment to be undermined by individual class members exercising their right of exclusion;

(h) to the extent that class members exercised opt-out rights for the purpose of prosecuting their individual suits, the desired economies would suffer and the risk of inconsistent decisions would increase.

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