

ANALYSIS



Hong Kong Corporations After the Handover: *Matimak* Revisited

Introduction

In an analysis comment in this Journal in 1998¹ Ken Lim, Sean Leonard and I noted with concern the decision of the United States Court of Appeals for the Second Circuit given in June 1997 in *Matimak Trading Co v Albert Khalily* ('*Matimak*').² The case dealt with the rights of Hong Kong corporations before the handover to sue in the federal courts of the United States of America. The US Court of Appeals for the Second Circuit concluded that Hong Kong corporations had no locus to sue in the US federal courts by way of the court's alienage jurisdiction.³ We pointed out the disturbingly adverse effects of the decision for Hong Kong corporations. I am pleased to report that a federal district court in the Second Circuit has recently concluded, in *Favour Mind Ltd v Pacific Shores Inc* ('*Favour Mind*'),⁴ that the status of Hong Kong corporations has now changed as a result of the handover on 1 July 1997. Assuming that this approach is followed by other US federal courts, the adverse effects of *Matimak* will no longer be relevant.

Matimak

To put the decision in *Favour Mind* in its proper perspective it is first necessary to revisit *Matimak*. *Matimak Trading Co* was a Hong Kong registered company that sued an individual and a New York corporation for breach of contract invoking the district court's alienage jurisdiction, which provides jurisdiction for the federal courts in any civil action arising between 'citizens of a State and citizens and subjects of a foreign State'. The two principal issues for determination were first whether Hong Kong was a foreign state for the purposes of the federal court's alienage jurisdiction and secondly whether a Hong Kong corporation was a citizen or subject of a foreign state, namely Great Britain. As to the first issue the Court of Appeals ruled that Hong Kong was not a foreign state; on the second issue the Court ruled that, although Hong Kong was a dependent territory of Great Britain, Hong Kong corporations were neither citizens nor subjects of that country. The Court, however, expressly limited its ruling with

¹ (1998) 28 HKLJ 16-29.

² 118 F 3d 76 (2d Cir 1997); cert denied 97-893.

³ Under 28 USC Sec 1332(a)(2) (1994).

⁴ 98 Civ 7038 (SDNY 7 December 1999).

respect to the jurisdictional status of Hong Kong corporations to the time period when Hong Kong was a British Dependent Territory. They expressed no view as to the future status of Hong Kong corporations after the resumption of sovereignty by the People's Republic of China ('China') on 1 July 1997.⁵ This decision was upheld by the United States Court of Appeals for the Second Circuit.⁶ The Supreme Court refused to entertain a further appeal.⁷ *Matimak* has subsequently been extended in the Second Circuit to corporations registered in the Cayman Islands⁸ and Bermuda,⁹ but the Court of Appeals for the Third Circuit¹⁰ (in respect of a Hong Kong corporation sued in the pre-handover era) and the Seventh Circuit¹¹ (in respect of a suit by a Cayman Islands corporation, where the decision preceded *Matimak*) have disagreed with the result reached in *Matimak*.¹²

Favour Mind

In *Favour Mind* the jurisdictional status of Hong Kong corporations in the post-handover period fell to the District Court to determine. At the outset of his judgment Judge Scheindlin acknowledged that the issue involved was one of substantial importance to international relations. *Favour Mind*, the plaintiff, was a company registered in Hong Kong that manufactures and sells clothing. It entered into a contract to sell specified clothing to the defendant, Pacific Shores, a New York corporation. The plaintiff alleged that it supplied the clothing as per contract to the defendant in New York, but the defendant failed, despite receiving invoices, to pay the sum due. The plaintiff filed suit in the Federal District Court in the Southern District of New York contending that the court had jurisdiction to determine the case since it involved a suit between a citizen of a State and a citizen or subject of a foreign state (ie it fell within the

⁵ 936 F Supp 151 (SDNY 1996).

⁶ Note 2 above.

⁷ 97-893; 1998 US LEXIS 693; 66 USLW 3491.

⁸ *United States Fidelity and Guaranty Co v Braspetro Oil Services Co* 97 Civ 6124 (SDNY 17 May 1999) (holding that *Matimak* was controlling and that a Cayman Islands Corporation was not a citizen or subject of the United Kingdom) and *Ill Finance Ltd v The Aegis Consumer Funding Group Inc* 99 Civ 2579 (SDNY 30 November 1999) (again holding that *Matimak* was controlling and was binding upon an action involving a Cayman Islands corporation).

⁹ *Klein v Marriott International Inc*, 34, F Supp 2d 176, 179 (SDNY 1999) (holding that *Matimak* was controlling in respect of the court's alienage jurisdiction over a Bermuda corporation) and *Koehler v Bank of Bermuda (New York) Ltd*, 96 Civ 7885 (SDNY 2 Sept 1998) (concluding that citizens of Bermuda were not subjects of a foreign state).

¹⁰ *Southern Cross Overseas Agencies Inc v Wah Kwong Shipping Group Ltd* 181 F 3d 410 (3d Cir 1999) (in accordance with a statement from the US State Department filed in the case, the court concluded that a Hong Kong corporation sued whilst Hong Kong was still a British Dependent Territory was a subject of the United Kingdom for the purposes of the court's alienage jurisdiction).

¹¹ *Wilson v Humphreys (Cayman) Ltd* 916 F 2d 1239 (7th Cir 1990); cert denied 499 US 947 (1991) (finding that court's alienage jurisdiction may be invoked by a Cayman Islands corporation).

¹² I would like to thank my colleague Andrew Byrnes for bringing these cases to my attention.

court's alienage jurisdiction). The defendant, citing *Matimak* in support of its contention, moved to dismiss the complaint on the grounds that the plaintiff was neither a citizen or subject of a foreign state.

The governments of both the United States and the Hong Kong Special Administrative Region filed amicus briefs before the hearing. Both governments contended that the plaintiff was a citizen of the 'foreign state' of China. The two main issues for determination were first whether Hong Kong was a foreign state and, secondly, whether the plaintiff was a citizen or subject of a foreign state, namely China.

Is Hong Kong a foreign state?

It had been held in *Matimak* that pre-handover Hong Kong was not a foreign state. In so deciding the court concluded that it had to defer to the executive branch of government on the question whether an entity had been accorded recognition as a foreign state. Hong Kong had not been accorded such recognition. In *Favour Mind* in its amicus brief the United States made it clear that it did not contend that post-handover Hong Kong was a foreign state. There was, therefore, no reason to differ from the conclusion reached in *Matimak* that Hong Kong was not a foreign state for the purposes of the exercise of the court's alienage jurisdiction.

Is the plaintiff Hong Kong corporation a citizen or subject of China?

In *Matimak* the court had concluded, looking, inter alia, at the British Nationality Act, that a Hong Kong corporation was not a citizen or subject of the United Kingdom; nor had the United Kingdom argued that Hong Kong corporations were citizens of the United Kingdom. In *Favour Mind* both the US and Hong Kong governments in their amicus briefs presented a diplomatic note from the government of China setting forth China's position regarding the citizenship of Hong Kong corporations. The note stated:

Hong Kong is an inalienable part of the People's Republic of China. The Hong Kong SAR is a local administrative region of the People's Republic of China, which shall enjoy a high degree of autonomy. Companies established in the Hong Kong SAR in accordance with its laws and decrees therefore enjoy the nationality of the People's Republic of China.

The court held that, because a foreign state is entitled to define who are its citizens and subjects, this explicit statement by China compelled the court to find that Hong Kong corporations were citizens of China and that the plaintiff was entitled to invoke the alienage jurisdiction of the federal district courts.

The court went on to say that there were other factors which pointed to Hong Kong corporations being citizens of China. The Joint Declaration¹³ provides that, upon reversion, the Hong Kong SAR 'will be directly under the authority of the Central People's Government of the People's Republic of China'. The Joint Declaration also recognises that the reversion of Hong Kong to China reflected a basic policy of 'upholding the national unity and territorial integrity' of China.¹⁴ Similarly the preamble to the Basic Law states that:

Hong Kong has been part of the territory of China since ancient times ... On 19 December 1984 the Chinese and British Governments signed the Joint Declaration on the Question of Hong Kong, affirming that the Government of the People's Republic of China will resume the exercise of sovereignty over Hong Kong with effect from 1 July 1997, thus fulfilling the long-cherished common aspiration of the Chinese people for the recovery of Hong Kong.

Finally the court noted that the Hong Kong SAR actively participates in the governance of China. For example, it appoints deputies as members of the National People's Congress.¹⁵ The judge pointed out that these examples of the clear connection and desire for integration between China and Hong Kong were in stark contrast to the relationship between Great Britain and Hong Kong which the *Matimak* court described as 'too attenuated' to confer British citizenship on Hong Kong corporations. The learned judge concluded that Hong Kong's relationship to China was materially different from Hong Kong's relationship to Great Britain with the result that Hong Kong corporations were citizens of China.

Policy considerations underlying the court's alienage jurisdiction

Finally Judge Scheindlin pointed out that the conclusion that Hong Kong corporations could assert alienage jurisdiction as a citizen of China found additional support in the principles underlying the court's alienage jurisdiction. Alienage jurisdiction recognised that foreign states were prone to hold the nation as a whole responsible for the treatment of its citizens. Accordingly, legal actions involving citizens of a foreign state ought to be heard in a federal (as distinct from a state) court, which was more accountable to the nation than to regional political interests. There was no doubt that the essential purpose of

¹³ The Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, paragraph 3(2).

¹⁴ *Ibid.*, para 3(1).

¹⁵ The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, article 21.

alienage jurisdiction would be severely frustrated if the court were to hold that Hong Kong corporations were neither citizens or subjects of China and were therefore not entitled to assert alienage jurisdiction. The overwhelming evidence indicated that China regarded the treatment of its nationals, including corporations of the Hong Kong SAR, as a matter of highest importance. A judicial finding that Hong Kong corporations were not citizens of China would engender precisely the harm to US foreign relations that the founders intended to forestall through the creation of alienage jurisdiction and it would frustrate the explicit interests of the United States, China and the Hong Kong SAR.

Conclusion

The decision in *Favour Mind* is very much to be welcomed. Hong Kong businessmen and women trading by way of a corporate structure with their counterparts in America can now take comfort from the fact that legal disputes can be resolved in the United States in the federal district courts rather than the state courts. The task of solicitors advising Hong Kong clients as to jurisdiction clauses in such contracts has also been facilitated. A note of caution must be sounded, however. As this decision is only a decision at the district court level in the Southern District of New York, it will not be binding on the Court of Appeals for the Second Circuit nor on federal courts in other districts. We can only express confident hope that the Court of Appeals for the Second Circuit will see fit to uphold the reasoning of Judge Scheindlin.

The position taken on this issue by way of amicus briefs by both the American and Hong Kong governments is also to be applauded, as is the diplomatic note from the mainland government recognising Hong Kong corporations as its citizens.

A comparison of the litigation in *Matimak* and *Favour Mind* also highlights a very concrete benefit accruing to Hong Kong as a result of its reversion to Chinese rule. Judge Scheindlin does not conclude that *Matimak* was wrongly decided; indeed, he may well agree with the decision, although he prudently refrains from any comment. He does, however, find the post-handover relationship between Hong Kong and China very different from the pre-handover relationship between Hong Kong and Great Britain; and that difference clearly runs in favour of Hong Kong corporations in the post-handover era.

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