

# **PART II – DIRECTORS’ LEGAL STATUS, POWERS AND DUTIES**

## **INTRODUCTION**

115. Part One dealt with the functions directors are required to perform as a company’s governing body and the corporate status of the company. Part Two looks at the legal status of directors and the powers, duties and consequential exposure to personal liability that derive from these functions and that status.

## **DIRECTORS’ LEGAL STATUS**

### **THE NATURE OF THE OFFICE**

116. Companies have a legal personality and can therefore enter into legal relationships but they need human agents to bring those relationships into being. They can hold property but need someone to look after it for them. They have requirements imposed on them by statute and therefore need properly designated officers upon whom a duty to ensure their compliance can be imposed and they need persons to represent their mind and will. These functions usually fall upon the directors and may also fall on other officers or employees. A directorship is a statutory office. Directors are not automatically employees or members of a company, but an individual may be an employee or member (i.e. shareholder) of a company as well as being a director (see paras 301 to 304 below).
117. A number of people who have not been formally appointed as directors may be treated as if they were directors.

### **“DE FACTO” AND “SHADOW” DIRECTORS**

118. As has already been discussed, a director is any person occupying that position, by whatever name called (Section 2 of the Companies Ordinance), and a director’s acts are valid, “notwithstanding any defect that may afterwards be discovered in his or her appointment or qualification” (Section 461 of the Companies Ordinance). In short, even though it is an offence not to comply with the formalities of registration of directors’ appointments (see paras 199 to 201 below) directors are recognised by their functions and by the authority and power they in fact exercise.
119. A “shadow director” is defined in the Companies Ordinance as any person in accordance with whose directions or instructions the directors of the company are accustomed to act. Under Section 3(2) of the Companies Ordinance, liability to a fine or penalty may extend beyond appointed directors to such “shadow directors”. Accordingly, liability can extend to banks, for example if directors of a defaulting borrower act on their instructions. Parent companies or directors of parent companies may also find themselves liable as “shadow directors”, where a “hands on” policy

is operated in relation to their management of a subsidiary. Examples of situations in which the liability of directors is extended to shadow directors include the following:

- Section 662 and Schedule 6 Parts 1 and 3 of the Companies Ordinance (relating to annual returns);
- Section 641 and Section 648 of the Companies Ordinance (relating to the maintenance of a register of directors and secretaries);
- Sections 168C to 168T of the WUMPO;
- Section 271 of the WUMPO.

### **PERSONS ASSOCIATED WITH A DIRECTOR**

120. The Companies Ordinance and other rules sometimes impose obligations on persons associated with a director or impose obligations on the director in respect of those persons. Some examples are given below.

- Companies are generally prohibited (subject to certain exceptions) from making direct or indirect loans to a director or another body corporate in which he or she has a controlling interest (including a joint or indirect interest) or providing guarantees or securities for any such loan. In the case of a listed company, or a company belonging to a group including a listed company, the prohibition is extended to loans to the director's family, the trustees of trusts whose beneficiaries include him or her or his or her family or partners of any of the same (see paras 162 to 177 below).
- A director, shadow director and chief executive of a listed company must notify that company and the HKEx of his or her interests and dealings in shares or debentures of that company or of associated companies of that company. For these purposes, interests of the director's spouse or children are treated as those of the director (see paras 178 to 183 below). There are many detailed provisions relating to this rule in Part XV of the Securities and Futures Ordinance (Cap.571).
- In the context of takeovers, a large number of obligations are imposed on "concert parties" by the Securities and Futures Ordinance and the Hong Kong Code on Takeovers and Mergers. Persons act in concert where, pursuant to an agreement or understanding (which need not be formal), they actively co-operate in the acquisition of shares in a company to obtain or consolidate control of that company. For example, directors may act in concert with each other, with their relatives or family trusts or with the company of which they are directors (see paras 244 to 248).

## **POWERS**

### **DIRECTORS' AUTHORITY TO ACT**

121. A company's powers and objects are given to it by law and by its Articles of Association. The exercise of these powers is usually delegated, as a general power of management, to the board of directors by the company's Articles of Association with certain powers, including composition of the board, reserved to shareholders. Any director must therefore familiarise himself or herself with the rules (Articles) of the company. He or she must observe any limits placed on the directors' own powers, normally by the Articles of Association.

### **CORPORATE CAPACITY-OBJECTS CLAUSE**

122. A company's action is still valid notwithstanding that it is beyond its object clauses (Section 116 of the Companies Ordinance).

### **WHO CAN COMMIT THE COMPANY?**

123. Directors' powers are not individual but collective. However, a board can, and does, delegate powers to committees or individual directors and in practice individual directors carry out many of a company's activities. An individual director who acts without the board having delegated the requisite authority can be liable for breach of duty to the company.
124. In cases where a company denies liability on a contract with an outsider because of some irregularity in the company's procedures or a lack of actual authority or appointment on the part of someone purporting to act on the company's behalf (rather than on the grounds that the contract was "ultra vires"), the outsider may nevertheless be able to claim that the contract is valid. He or she might rely on the "indoor management rule" of *Turquand's case* (1856) or claim that the person purporting to contract on behalf of the company had "apparent authority".
125. The rule in *Turquand's case* protects a person dealing with a company in good faith and without notice of the fact that the company's internal management requirements have not been followed. An outsider is entitled to assume that all internal procedures and requirements of the Articles of Association have been complied with unless he or she is alerted to the fact that this is not the case.

126. An outsider may alternatively claim that the person purporting to contract on behalf of a company had apparent or usual authority to do so, even if he or she had no actual authority or sanction from the board of directors. Apparent or usual authority can arise in a variety of ways but generally, if a representation is or has been made by a person who has actual authority to manage the business that another person has authority to act on behalf of a company, or holds a position in the company which would normally give him or her authority, the company could be bound by contracts entered into by such a person. In short, does he or she apparently have authority or would it be usual for such a person to have authority?
127. To conclude, this means that a company will be bound by a transaction authorised by the board as a whole. However, it may also be bound by a transaction entered into by a managing director or an individual director and probably by one entered into by a “local” director (see para 93 above) or other employee having the apparent authority to enter into contracts of the type in issue, whatever the state of the actual authority of the individual concerned.

## CONTROL OF ABUSE OF POWERS

### Members’ Rights

128. A director’s duties relate to the company as a whole and therefore, prima facie, fall to be enforced by the company as a whole. The underlying rule (known as the rule in *Foss v. Harbottle*, from the 1843 English case in which it was enunciated) is that a duty owed to the company can only be enforced by the company and not by individual shareholders. Moreover, if the members were permitted, and willing, to ratify a breach of duty, the approval of a bare majority would often suffice, depending on the relevant provisions of the company’s constitution.
129. This rule can have very harsh consequences for minority shareholders and lead to an abuse by directors of their powers for two reasons in particular. Firstly, it is often the case that the majority shareholders are also directors and will therefore be able to ratify their own breaches of duty. Secondly, since as a general rule proceedings on behalf of the company must be taken by the directors, they can avoid their breach of duty being challenged in the first place. This is why most of cases relating to breach of directors’ duties have been brought after control of the company has changed hands or by liquidators of insolvent companies after the directors’ powers have lapsed.
130. There has accordingly been a considerable body of law devoted to giving minority shareholders adequate protection without unduly limiting the powers of directors acting lawfully under their general power of management. Protection has been granted by statute and by way of exceptions to the general rule in *Foss v. Harbottle*.

## Exceptions to *Foss v. Harbottle*

131. Exceptions to the *Foss v. Harbottle* rule enable an individual shareholder to take proceedings against the persons who control the company (including directors who are majority shareholders) where the act complained of:
- is ultra vires or illegal (so called “personal rights” actions);
  - should have been sanctioned by extraordinary or special resolution, and was not;
  - infringes the rights of an individual shareholder in his or her capacity as a member of the company;
  - is a fraud on the minority by those controlling the company – for instance, by the expropriation of company property. Negligence could be treated as a fraud on the minority if the directors’ negligent use of their powers result in their improperly receiving a benefit at the expense of the company.
132. In addition to these exceptions, the *Foss v. Harbottle* rule’s emphasis on control through majority ownership was partially eroded by the case of *Prudential Assurance Co Ltd v. Newman Industries Ltd* (1980) in which the court was prepared to entertain an action brought by a minority shareholder against directors who did not hold a formal controlling interest, and to accept that such an action might be both derivative (i.e. brought in the company’s name) and representative (i.e. brought by one shareholder on behalf of all).

## Statutory Protection

133. The Companies Ordinance requires that certain actions of the company require a special (75% majority) rather than an ordinary (simply majority) resolution of the members in general meeting. Those actions include altering the company’s rules as stated in the Articles, reducing in any way the company’s capital (which may also require approval of the court) and winding up the company. Shareholders may also apply to the court to have certain resolutions cancelled.
134. A number of provisions of the Companies Ordinance also grant powers to certain groups of minority shareholders, including the ability to requisition an Extraordinary General Meeting and to requisition resolutions at the company’s next Annual General Meeting. They may also apply to the Financial Secretary to appoint inspectors to investigate the affairs of a company (Section 840 of the Companies Ordinance).
135. Another important statutory protection is afforded by Sections 722-726 of the Companies Ordinance. This Section enables any “member of a company who complains that the affairs of the company are being or have been conducted in a manner unfairly prejudicial to the interests of members generally or of some part of the members (including himself or herself)” to petition the court for relief.

136. The Financial Secretary may also petition the court under Sections 722-726 of the Companies Ordinance on receipt of an Inspector's report or under his or her own powers, as may a shareholder in a quasi-partnership company who has been excluded from sharing in the management of that company due to a breakdown in the relationship between the parties.
137. The court, if satisfied that the petition is well founded, has the widest discretion to make orders as it thinks fit. In particular, it may regulate the company's affairs in the future, order it not to do something which the petitioner has complained of, or it may order the company to do something which the petitioner has claimed it has omitted to do. It may also provide for the purchase of the shares of any members by other members or by the company itself, as long as a fair price can be determined.
138. Most importantly for directors, the court can authorise civil proceedings to be brought in the name of the company by such person as it may direct, e.g. for breach of duty against a director where the company itself refuses to act.

### **Ratification**

139. If directors exceed the company's powers granted by the Articles of Association, but the shareholders are willing to accept the act as the company's own, the act may be ratified by an ordinary resolution of the shareholders. However, ratification is not possible if the act is unlawful.

### **ACCESS TO INFORMATION**

140. An individual director is entitled to all information he or she deems necessary to enable him or her to carry out the duties of the office so long as it is required bona fide in the interests of the company and not for some ancillary purpose (e.g. exclusively for the benefit of a holding company).

## ***DUTIES – GENERAL***

### **INTRODUCTION**

141. Sections 453, 462, and 465 of the Companies Ordinance group together some general provisions about appointment, removal, qualifications, duties and responsibilities. Other more specific requirements are imposed on directors elsewhere in the Ordinance. Many of the most important features of a director's duties are, however, based on the decisions of generations of judges creating and interpreting the law and a large number of duties are created by enactments well outside the traditional ambit of company law.

The Old Companies Ordinance did not contain specific provisions on directors' duty of care, skill and diligence, and general common law and fiduciary duties of directors are based on case law. However, the New Companies Ordinance clarifies a director's duty to exercise reasonable care, skill and diligence. Section 465 of the New Companies Ordinance requires a director to exercise reasonable care, skill and diligence, meaning the care, skill and diligence that would be exercised by a reasonably diligent person with:

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (an objective test); and
- (b) the general knowledge, skill and experience that the director has (a subjective test).

Therefore, in carrying out his or her duties, a director must bring to bear his or her own general knowledge, skills and experience (a subjective test), as well as the knowledge, skills and experience that would reasonably be expected of a director carrying out the same functions (an objective test). If a director has special knowledge, skill or experience, then such director will be subject to a higher standard of care under the New Companies Ordinance compared to a director without such knowledge. Conversely, a director will still be expected to meet an objective reasonable standard of care, even if the director is in fact under-qualified for the role.

142. Directors' duties can be generally classified as:

- Direct – where a director is required to act in a particular way for the benefit of the company or of a third party;
- Indirect – where the company is required to act in a particular way for the benefit of third parties or in the general public interest and an obligation is placed on the directors to ensure that it does so;
- Incidental – where other people as well as directors are required to discharge a duty, but where the nature of directors' functions means that it is particularly likely that the directors will have to discharge it.

### **THE DIRECTORS' FIDUCIARY DUTY TO THE COMPANY**

143. Directors owe a fiduciary duty to their company. This means that they must at all times act honestly and diligently, showing the company their highest loyalty, acting in good

faith and in the company's best interests. It is convenient to express this complex duty as falling into three categories:

- To act honestly, bona fide for the benefit of the company.
- To exercise their powers for a proper purpose.
- Not to allow any conflict between their duties as directors and their personal interests.

### **HONESTLY, "FOR THE BENEFIT OF THE COMPANY"**

144. This is the broadest expression of a director's fiduciary duty and inevitably overlaps with the other categories.
145. As the company's agents, directors must use their discretion, but whatever decision they take must be within the company's objects and be in the interests of the company and not for any collateral purpose, nor for a personal motive. The benefit of the company can be taken to mean the interests of its members, present and future (i.e. the interests of the company as a corporation). The directors may therefore legitimately balance a long-term view against short-term interests of present members.
146. A company's best interests are sometimes hard to define. For example, how should the nominated board of a subsidiary act in relation to the parent company that appointed them? The correct answer is that they owe their duty to the subsidiary in priority to the interests of other group companies. They are, of course, entitled to give due consideration to the view that benefiting the group and its component companies could also benefit their own company. What is in the interests of company may be a matter of the directors' opinion, subject to their overriding fiduciary duty, and the courts recognise this.
147. Directors have certain of the attributes of trustees as regards property of the company which is in their hands or under their control. They must ensure that it is not misapplied. The definition of property is a wide one, including not only tangible assets, such as cash at bank, but also such items as trade secrets and know-how. A misapplication would include any disposition of the company's property which ought not to have been made due to it being forbidden by an ordinance or by the Articles of Association of the company, or from the disposition being in breach of the directors' duty to act bona fide in the best interests of the company and for a proper purpose. Many of the instances where directors have been held responsible in this way are summarised in a paraphrase from the old case of *Re Sharpe* (1892), i.e. as soon as it is demonstrated



that a company's asset has been applied by the directors for purposes which the company cannot sanction, the directors become personally liable for its re-instatement, however honestly they may have acted.

### **“PROPER PURPOSE”**

148. Directors must not use their powers for an improper purpose.
149. Even if a director acts honestly and diligently, reasonably believing that the transaction about to be approved is for the benefit of the company, that will not be enough if the transaction is based on an improper use of the director's powers.
150. Directors must not use their powers under the Articles for a purpose for which they were not intended. An example from the past is directors using their powers to issue shares, not for their proper purposes (to raise capital needed by their company), but to forestall a takeover bid. Such an action was held to be an improper use of the directors' powers to issue shares and therefore a breach of duty, even though the directors may have believed they were acting in the company's best interests. However, such a breach is an example of one which may be capable of ratification by the shareholders in general meeting.

### **“CONFLICT OF INTEREST”**

151. A director must not take personal advantage of the company's opportunities and allow their personal interests to conflict with those of the company nor misapply the company's assets. The court expects a very high standard of honesty from all fiduciaries and will apply very stringent tests as to what constitutes impropriety, personal advantage or misapplication. This aspect of a director's fiduciary duty demands a more detailed explanation.

## ***DUTIES – CONFLICTS AND DECLARATION OF INTEREST***

### **SECRET PROFITS**

152. If a director makes a personal profit through the use of the company's property without it being disclosed to the company, that profit belongs to the company and the director is under a duty to account for it to the company. This principle has been extended by the courts to profits arising from a director making use of a corporate opportunity. It makes no difference that the profit is one which the company could not itself have made if the director had not deployed his or her own resources to making it, nor that he or she acted in good faith, nor that there was no actual loss to the company. The required elements are simply that what was done resulted in a profit to the director

concerned, was not disclosed to the company and related to the company's affairs in such a way that it could be said to have been done in the course of the director's management or was an opportunity which came about by virtue of his or her position in the company of his or her special knowledge as a director.

153. Full disclosure to the board will probably not help in this situation. It is even doubtful whether the director's liability to account can be excused by a resolution of shareholders. There has been a suggestion by the court that the use of the opportunity could be approved by general meeting but the position is unclear.

## **CONFLICTS AND DECLARATION OF INTEREST**

154. Like other fiduciaries, directors are required not to put themselves in a position where there is a conflict (actual or potential) between their personal interests and their duties to the company.
155. Some conflicting interests may be permitted if, and only if, they are disclosed to the company. Thus a non-executive director may be interested in a business which competes with his or her company, provided that he or she does not thereby break the director's fiduciary duty by, for instance, misappropriating the trade secrets or trade opportunities of the company. However, the connection with such a business must be made known both to fellow board members and to the shareholders.
156. The no conflict rule might be expected to prohibit a person from being a director of competing companies. In fact, the position is unclear. The courts have, in the past, been prepared to countenance this, but no great reliance should be placed on their willingness to do so in the future. In any event, a director may find that the Articles of the company or his or her own service contract demand that he or she devotes himself or herself full time to the company's business.
157. The principle of declaration of interest is strengthened by Sections 536-8 and 542 of the Companies Ordinance which requires directors to disclose to the board their interest in any contract made by the company. Failure to do so is an offence, for which a fine can be imposed. Most company Articles contain a similar provision requiring disclosure of interests in contracts. A contract for the purposes of Sections 536-8 and 542 of the Companies Ordinance means a contract which is of significance in relation to the company's business.

## **TRANSACTIONS BETWEEN DIRECTOR AND COMPANY**

158. There are complex statutory provisions governing the areas where conflicts of interest are most likely to arise, namely, contracts between a director and a company (service contracts), loans by a company to a director, and dealings by directors in

their company's shares. In public companies, transactions are usually considered as connected transactions under the Listing Rules and depending on the size of the transaction, it would require reporting to the HKEx and sometimes shareholders' approval. If contemplating any transaction in these areas, directors are strongly advised to seek professional advice.

(i) ***Service Contracts***

159. Despite the shareholders' nominal control over an individual's appointment and removal as director, executive directors are often protected by long-term employment contracts as employees of the company (see paras 301 to 304 below). The high cost of compensation on removal can therefore act as a deterrent, and make it expensive for the shareholders to exercise their powers. In an endeavour to redress the balance in the U.K., the Companies Act requires the express approval of a company in general meeting for any arrangement which would effectively give a director a fixed term service contract for a period of more than five years. Such a provision has not yet been adopted in Hong Kong.
160. Under Section 462 of the Companies Ordinance the members of a company (by ordinary resolution) may remove a director before the expiration of his or her period of office notwithstanding anything in its Articles or in any agreement between him or her and that company. The Section expressly clarifies that this will not deprive a person removed as director of compensation or damages.
161. Under Sections 517-8, 520 and 524 of the Companies Ordinance a bona fide payment to a director by way of damages for breach of contract (or a pension or similar payment) does not require the sanction of the members of the company in general meeting. However, other payments by way of compensation for loss of office must be approved by the members in general meeting.

(ii) ***Loans to, and similar transactions with Directors***

162. The Companies Ordinance contains rules governing loans and similar transactions in favour of directors and certain connected persons. "Directors" in this context are directors of the company concerned and directors of any holding company it may have. Connected persons include those referred to at para 120 above.

**The General Rule**

163. The general rule is that all companies can provide loans to directors subject to shareholders' approval.

164. The loans are still subject to detailed and lengthy provisions relating to disclosure in the financial statements and accounts of the company and, where applicable, the consolidated accounts of the group (see paras 173 to 177 below).
165. Loans to directors have been relaxed. All companies can now provide loans to directors if approved by shareholders. If the loan is in the form of a quasi-loan or credit transaction, further restrictions apply.

In addition, the following loans do not require shareholders approval:

- (1) Expenditure on company business
- (2) Home loans and leasing of goods or land
- (3) Loans under the business of the creditor
- (4) Intra-group transactions
- (5) Small loans not exceeding 5% of the company's net assets
- (6) Expenses for defending court proceedings

### **Private Companies – Members' Approved Loans**

166. Anything done by a private company which has been approved by the company in general meeting unless the company is a member of a group which includes a listed company.
167. – 172. Deleted

### **Disclosure of Loans and Other Transactions with Directors**

173. Under Sections 383, 407-8, 451-2 of the Companies Ordinance the accounts to be laid before the company in general meeting must include particulars of the following loans:
- (a) A loan made to a person who was an officer of the company or a director of its holding company at any time during the preceding financial year;
  - (b) A loan made to a company in which a director, jointly, severally, directly or indirectly, held a controlling interest at any time during the preceding financial year;
  - (c) A loan made by a listed company (or a company which is a member of a group of companies that includes a listed company) to: i) a person connected to a director of the company at any time during the financial year; or ii) a person connected with a director of the company's holding company at any time during the financial year; or iii) a company in which a person connected to a director held a controlling interest (whether jointly, severally, directly or indirectly). (See para 120 for examples of connected persons). The said loan must be one made during

that financial year or if made before this, is outstanding at any time during that financial year.

174. The accounts must also include details of guarantees entered into and security provided by a company in connection with any of the above types of loan if the liability of the company in respect of such guarantees or security has not been discharged by the end of the preceding financial year.
175. The Ordinance requires many details relating to the transaction or arrangement to be disclosed. These include the name of the director, borrower and (where appropriate) relevant connected person(s), the terms on which the transaction was entered into, the amounts outstanding or value of the transaction at the beginning and at the end of the financial period and the maximum amount or value at any time during the period. In the case of loans, the amount of unpaid interest due and of any provision made by the company in anticipation of non-payment must also be disclosed. Amounts paid and liability incurred by the company in fulfilling any guarantee or discharging any security (including any loss thereby incurred) must be disclosed. Failure to disclose this information can lead to a director being fined.
176. The disclosure requirements above do not apply in relation to:
- The accounts of banks and deposit taking companies (and their holding companies) in respect of loans and similar transactions for the benefit of directors and connected persons to which the bank is a party-different disclosure provisions apply;
  - Any loan made by a company or its subsidiary to any of their employees if the loan does not exceed HK\$100,000, is certified by the directors to have been made in accordance with the normal practice of lending to employees adopted by such company or subsidiary, and such loan is not guaranteed or secured by a company in the same group.

## **Penalties**

177. Where a transaction is entered into in breach of the restrictions on loans to directors, subject to protecting innocent third party rights, the person receiving the loan is liable to repay it to the company. As a general rule any guarantee or security given in breach of the provisions is unenforceable but the rule does not apply if, broadly, innocent third party rights are affected. The director and connected person (if any) who benefit from a transaction in breach of the provisions, together with any director who knowingly and wilfully authorised or permitted the transaction, must account to the company for any gain made and are jointly and severally liable with other directors to indemnify the company for any loss. Relevant companies and their directors are also liable to criminal sanctions.

(iii) **Directors' Shareholdings**

178. The Institute favours the holding of shares by directors, provided they are held as a long-term investment. The Articles of some companies require directors to hold qualification shares. Directors should not, however, use their special knowledge to deal in their company's shares. If they do, they are in breach of their fiduciary duties to the company and are in the same position as a director making a secret profit (see paras 152 to 153 above). They may also be guilty of insider dealing (see paras 184 to 189 below). The Institute recommends a complete moratorium on directors' personal share trading during the month prior to the publication of a company's accounts.

**Disclosure of Shareholdings**

179. Because such dealings may be concealed, for instance behind nominees, there are a number of statutory provisions which seek to control them in the case of listed companies. The Securities and Futures Ordinance provides that directors, chief executives and shadow directors must disclose their "interests" in shares or debentures of their (listed) company and associated companies and all changes in such interests.
180. "Interests" of directors in shares (as opposed to interests of shareholders in shares of listed companies where different rules apply) is very widely defined. It includes acquiring shares or debentures of the company or any member of the company's group and disposing of such shares or debentures. A director is also interested in such shares if he or she enters into a contract for their purchase or subscribes to a rights issue. In addition, a director is taken to be interested in the shares or debentures of a company which are held by another body corporate if the director controls one-third or more of the voting power at general meetings of that body corporate, or if that body corporate is accustomed to acting in accordance with the director's instructions.
181. The obligation on a director to disclose "interests" extends to interests of his or her spouse and infant children.
182. Disclosure must be made to the company and to the HKEx, in writing, within three business days of acquiring an interest or of any change in interest.
183. Every listed company must keep a register to record the information so notified and detailed rules govern by when and how entries must be made.

## INSIDER DEALING

184. Insider dealing is not only a breach of directors' duties; it is also a contravention of the insider dealing provisions of the Securities and Futures Ordinance ("SFO"). It is the duty of every officer of a company to ensure that proper safeguards exist to prevent the company from acting as an insider dealer.
185. The SFO also makes a number of activities based on the use of inside information offences which may lead to penalties being imposed by the Insider Dealing Tribunal. Briefly, certain persons (being companies, partnerships or individuals including employees, whether directors or not), must not deal on their own account on a recognised stock exchange, or off-market, in securities of a company if, by virtue of their connection with the company, they have confidential, unpublished price-sensitive information relating to those securities. The prohibition covers persons who are connected with the company in question, and all persons who have knowingly obtained, directly or indirectly, information from such individuals. If an offence is committed by a company with the consent or by the neglect of its officers, both the officers and the company are guilty of the offence.
186. A similar provision prohibits individuals connected with one company from dealing in securities of a second company where, by virtue of being connected with one company, that individual has confidential unpublished price-sensitive information about a transaction involving the two companies.
187. Insiders with confidential unpublished price-sensitive information are also prohibited from counselling or procuring others to deal in securities and from passing on such information to third parties.
188. Although it is possible that, in the case of insider dealing, a person to whom shares have been transferred may in some circumstances be able to claim rescission of the contract on the grounds of misrepresentation or fraud, the provisions do little to make it easier for the company, its shareholders or third parties who may suffer, to recover their loss. A transaction caught by the above provisions is neither automatically void nor voidable by reason of an insider dealing.
189. Insider dealing is not the only securities related offence which is provided for under the SFO. The SFO regards as offences several types of market misconduct, namely: insider dealing; false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions, or stock market manipulation. The possible penalties for such offences include varying degrees of fines and imprisonment.

## **DUTIES ARISING FROM THE COMPANIES ORDINANCE AND ASSOCIATED LEGISLATION**

190. Under Sections 9, 66-7 and 84 of the Companies Ordinance) companies may be formed easily, speedily and cheaply:

“Any 1 or more persons, associated for a lawful purpose may, by subscribing their names to an Article of Association (which must be printed in the English language) and otherwise complying with the requirements of this Ordinance in respect of registration, form an incorporated company, with or without limited liability”.

191. The rest of the Companies Ordinance and the extensive legislation associated with it exists, inter alia, to spell out the mechanism for formation, identification and the formalities of registration and to deal with and regulate the consequences of incorporation and limited liability for shareholders and creditors. The means chosen to ensure that companies are run properly include:

- Disclosure – companies are required to make public a great deal of information about their affairs;
- The creation of statutory rights for shareholders and creditors;
- Elaborate requirements to ensure that a company’s capital is maintained;
- The appointment of suitable officers;
- Provisions to ensure fair dealing by officers.

192. The last item in this list relates to directors’ general fiduciary duties and has already been covered. Matters relating to their appointment are dealt with in Part Three (see paras 294 to 300 below).

193. Many elements of the categories listed above create additional duties, directly or indirectly, and corresponding liabilities for directors. Penalties may be imposed on the company and directors jointly and severally or on either party alone, if these duties are breached. We will now look at these duties in more detail.



## ***DUTIES – DISCLOSURE, REPORTING AND ACCOUNTING***

### **DISCLOSURE**

194. Companies are required to disclose information in a number of ways:
- By including information on printed material;
  - By making returns to the Registrar of Companies which are available for public inspection;
  - By making available documents for inspection at the company's registered office, or elsewhere;
  - By circulating information to shareholders in the form of reports and accounts and to prospective investors in the shape of prospectuses or listing particulars.
195. In all cases these documents should be prepared and processed by individuals with the requisite qualifications but the ultimate responsibility for meeting disclosure requirements falls on the board, whose members may face hefty financial liability or penalties for any incorrect or misleading statement of default (including the risk of being disqualified from acting as a director-see paras 308 to 317 below).

### **LETTERHEAD AND PUBLICATION OF COMPANY NAME**

196. Under Sections 659-661 of the Companies Ordinance the full name of a company, including any Chinese characters forming part of the name, must be shown without abbreviation (except certain permitted abbreviations mentioned in the Ordinance) in the following places:
- At a conspicuous place outside its registered office and every other office where it carries on a business;
  - On its company seal;
  - In legible characters on all business letters, notices and other official publications, and in all contracts, deeds, bills of exchange, cheques, promissory notes, endorsements, orders for money and goods, purporting to be signed by or on behalf of the company, consignment notes, invoices, receipts and letters of credit of the company. These documents must also state the fact that the company is incorporated with limited liability.

197. Directors and other officers may be made personally liable on cheques, bills of exchange, promissory notes or orders for money or goods if the above provisions are not complied with.
198. There is no requirement to display the names of the company's directors on business letters and other documents, or at the registered office of the company.

### **RETURNS TO THE REGISTRAR**

199. For companies registered in Hong Kong, documents relating to the following matters must be filed with the Registrar of Companies:
  - The Articles of Association;
  - Appointment and resignation of directors and the Company Secretary;
  - The company's Registered Office;
  - The following resolutions:
    - special resolutions of general meetings of shareholders;
    - agreements between shareholders having the same effect as such resolutions;
    - resolutions and agreements which bind all members of a class of shareholders;
    - ordinary resolutions which increase the company's authorised capital, authorise the directors to allot shares, require the company to be wound up voluntarily or which vary any provision in the Articles of Association;
  - Alterations to share capital;
  - Allotments of shares;
  - Most charges on company property;
  - The statutory annual return;
  - Removal of auditors;
  - Purchase of a company's own shares;
  - Winding up.

## **DOCUMENTS WHICH THE COMPANY MUST MAKE AVAILABLE FOR INSPECTION**

200. The following documents must be available for inspection by the public:

- A register of members (or shareholders);
- A register of debenture holders (if any);
- A register of directors and secretaries;
- A register of directors' interests in the shares of the company (if listed) (see paras 179 to 183 above);
- A register of charges.

As a general rule these documents should be available for inspection by the public for at least two hours each day.

201. These documents are to be kept at the company's Registered Office but may be kept elsewhere within Hong Kong at the place where the work in completing such registers is carried out, provided notice of where they are kept is given to the Registrar.

## **THE COMPANY'S ACCOUNTS**

202. A company's accounts must normally comprise a profit and loss account, balance sheet, an auditors' report, a directors' report and any notes required to explain the accounts. In addition, where a company is listed, it must comply with the financial disclosure requirements set out in the HKEx's Listing Rules (see para 230 below).

203. Whilst every director is not required to be a technical expert in accounting, or to know the statutory codes in detail, the responsibility for compliance with the requirements of the Companies Ordinance on accounts and, where applicable, the HKEx Listing Rules, rests squarely on directors' shoulders and every director should therefore be aware of at least the broad outline of them. These requirements are contained in Sections 367-436 of the Companies Ordinance.

204. It is the duty of the directors under the Ordinance:

- To ensure that proper and accessible accounting records are kept by the company;
- To approve annual accounts prepared in compliance with the Ordinance;

- To ensure that the company sends copies to parties entitled to receive them;
- To lay the accounts before members in general meeting within prescribed time limits.

If any director fails to take all reasonable steps to secure compliance by the company with its obligations in relation to its accounts, he or she may be liable to a fine and imprisonment.

### **Accounting Records**

205. Accounting records are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions.

### **Format and Preparation of Annual Accounts**

#### ***Accounting Standards***

206. The Companies Ordinance sets out the general requirement that any accounts must give a true and fair view of the state of the company's affairs and explain its transactions. Despite the fact that the Companies Ordinance has not given a clear definition of the phrase 'true and fair view', there is a general understanding that compliance with Statements of Standard Accounting Practice ("SSAPs") as issued by the Hong Kong Institute of Certified Public Accountants, and the International Accounting Standards (IAS) as issued by the International Accounting Standards Committee, where applicable, will ensure the giving of a true and fair view by the company's accounts. These standards should be complied with unless particular circumstances justify a departure from them.

#### ***Groups***

207. The directors of a Hong Kong company are required to produce group accounts dealing with the state of affairs and profit or loss of the company and all its subsidiaries. These group accounts must be laid before the holding company at its general meeting and must comply with the provisions of the Companies Ordinance as to form and content. The group accounts are not required to deal with a subsidiary of the company if the company's directors are of the opinion that:
- It is impracticable, or would be of no real value to members of the company, in view of the immaterial amount involved, or would involve expense or delay out of proportion to the value to members of the company; or

- The result would be misleading, or harmful to the business of the company or any of its subsidiaries; or
- The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

The approval of the Financial Secretary is required in order to take advantage of such exemption.

208. A company will be regarded as a subsidiary of another company if that other company:
- Has the power to control, directly or indirectly, the composition of the board of directors of the first-mentioned company; or
  - Controls more than half of the voting power of the first-mentioned company; or
  - Holds more than half of the issued share capital of the first-mentioned company.

### ***Exceptions for certain private companies***

209. Section 359 of the Companies Ordinance allows a private company (except for banking and insurance companies and certain private companies) to waive compliance with certain requirements as to accounts as long as the company obtains the written approval of all its shareholders each financial year. Such private company is only required to produce simplified accounts comprising a shortened directors' report and a simplified profit and loss account and balance sheet although certain matters such as payments to directors are still required to be disclosed.

### **Directors' Report**

210. Directors of every company are required to prepare a report with respect to the profit or loss of the company for the financial year and the state of the company's affairs as at the end of the financial year. The report must be attached to every balance sheet laid before the company in general meeting. The matters to be included are set out in Sections 388-391 and Schedule 5 of the Companies Ordinance and include a business review report.

A copy of the directors' report must be sent to every share and debenture holder of the company together with a copy of the accounts and the auditors' report.

## **Approval of Annual Accounts and Directors' Report**

211. Every balance sheet of a company shall be approved by the board of directors of the company and signed on behalf of the board by 2 of the directors (or the sole director in a one-person company). In the case of a company carrying on banking business, the balance sheet shall be signed by the secretary or manager, if any, and where there are more than 3 directors of the company by at least 3 of those directors, and where there are not more than 3 directors by all the directors.
212. If any copy of a balance sheet which has not been signed as required is issued, circulated or published, the company and every officer of the company who is in default shall be liable to a fine.
213. Every directors' report to be attached to the balance sheet shall be approved by the board of directors and signed on behalf of the board either by the chairman of the meeting at which it was approved or by the secretary of the company.
214. If the directors' report fails to comply with the Companies Ordinance's requirements about preparation and content, every person being a director of the company shall be liable to imprisonment and a fine, unless he or she can prove that he or she took all reasonable steps for securing compliance with the requirements.

## **Publication, Laying and Filing Accounts and Reports**

215. The directors must ensure that the company sends a copy of the annual accounts, with a copy of the directors' and the auditors' reports, to every member of the company, debenture holder and person entitled to receive such accounts. These must be sent not less than 21 days before the meeting at which those documents are to be laid.
216. The directors must lay the annual accounts for each financial year, together with the directors' report and the auditors' report, before the company at its annual general meeting. The period for laying and delivering accounts runs from the end of the company's accounting reference period, that is normally the end of the company's financial year, and cannot exceed:
  - For private companies – nine months;
  - For public (including listed) companies – four months.

217. If accounts are not laid or delivered within the prescribed time, or if they fail to comply with the requirements on laying and delivering in some other way, every director in office is guilty of an offence and may be liable to imprisonment and a fine, unless he or she can prove that he or she took all reasonable steps for securing compliance with the requirements.
218. It is absolutely essential for listed companies to have regard to the Listing Rules to check the required inclusion of information in the listed group's annual, interim and quarterly (for GEM companies) reports and accounts, as well as in preliminary announcements of financial results, and also note the time within which interim and quarterly reports must be provided after the end of the period in question.

## **AUDITORS**

219. The general definition of "officer" of a company set out in the Companies Ordinance does not apply to an auditor, but in certain circumstances under the Ordinance he or she is treated as an officer.

### **Appointment and Removal**

220. The statutory provisions relating to the appointment etc. of auditors of limited companies can be found in Sections 393-422 of the Companies Ordinance.
221. A person shall not be appointed as auditor of a company unless qualified under the Professional Accountants Ordinance. Auditors must be independent of the company by not being any other type of officer or employee of the company, nor a partner or employee of such a person, nor someone disqualified from acting as auditor of the company or of any other group company. An auditor cannot be a limited company.
222. Auditors must be appointed at each annual general meeting to act until the next such meeting, when they can either be reappointed or replaced. If a casual vacancy arises due to the disqualification, removal or resignation of auditors before the end of their period of office, the directors, or the company in general meeting, may appoint other auditors to fill the vacancy. Auditors appointed in this way will be reappointed or replaced by the company at its next general or annual general meeting.
223. The company in general meeting may remove auditors by an ordinary resolution, notwithstanding any term in any agreement between them. Notice of such a resolution must be given by the company to the Registrar of Companies within fourteen days (except in respect of auditors of a private company).

224. Special notice must be given of the intention to move resolutions at general meetings appointing or removing auditors. In the case of removal, the auditors must be told and have a right to attend and be heard at the general meeting.
225. Auditors may resign at any time by depositing a notice in writing to the Registered Office of the company. Such a notice must either:
- State that there are no circumstances connected with their resignation which the auditors consider should be brought to the attention of the members or creditors; or
  - Contain a statement of any such circumstances. In the latter case, a copy of the notice of resignation must be sent by the company to all members and other persons entitled to receive copies of the balance sheet and auditors' and directors' reports. In addition, the auditors may require the directors to convene an Extraordinary General Meeting to consider the matter.
226. In any event a notice of the resignation must be sent by the company to the Registrar of Companies.

### **Powers and Duties**

227. Auditors have rights and duties. They have the right to receive notice of, attend and be heard at all meetings of the company's members – but not meetings of the board or management. They have a right of access at all times to the company's books, accounts and vouchers, and the right to require the officers of the company to give them such information and explanations as they consider necessary for the execution of their duties. A subsidiary (and its auditors) must give to its holding company's auditors such information and explanations as they reasonably require. If the auditors have been unable to obtain all the information and explanations which, to the best of their knowledge and belief are necessary for their audit, they must state this fact in their report.
228. In summary, their principal duty is to make a report to members on the company's accounts, stating whether they have been properly prepared in accordance with the Ordinance and whether they give a "true and fair view" of the company's financial position. However, in relation to private companies which have taken advantage of the provisions enabling them not to publish full accounts (see para 210 above), the auditors need only to state whether the balance sheet shows a true and correct view of the company's financial position.



229. A “dormant” company (i.e. one which has had no significant accounting transaction during the financial year) need not appoint auditors, provided it complies with the procedure laid down by Section 5 of the Companies Ordinance.

## **HONG KONG EXCHANGES AND CLEARING LIMITED DISCLOSURE REQUIREMENTS**

230. Companies listed or applying for listing on the HKEx must satisfy the basic conditions for listing and comply with the relevant listing rules. Indeed, part of the documentary requirements for listing include a declaration and undertaking from directors that they will use their best endeavours to procure the company’s compliance with the Listing Rules. Reference to the Exchange’s current rules is essential as they are of mandatory force and require the circulation to shareholders of information not necessarily required by the Companies Ordinance. There have, for example, been significant amendments to the financial disclosure requirements. These amendments require the disclosure of additional information in annual accounts and listing documents which, amongst other things, include:–

- Directors’ emoluments on a named basis and senior management compensation;
- Details of directors and senior management;
- Pension schemes and costs;
- Major customers and suppliers;
- Management discussion and analysis;
- Details of reserves available for distribution to shareholders.

231. The directors should acknowledge their responsibility for preparing the accounts, and there should be a statement by the auditors about their reporting responsibilities. The directors should prepare the accounts on a going concern basis, with supporting assumptions or qualifications as necessary. When the directors are aware of material uncertainties relating to events or conditions that may cast significant doubt upon the company’s ability to continue as a going concern, such uncertainties should be clearly disclosed.

## **DUTIES IN RESPECT OF SHARES AND SHAREHOLDERS**

### **DISTRIBUTIONS AND DIVIDENDS**

232. The company's policy relating to the declaration and payment of dividends will be found in the company's Articles, which should be consulted, since the division of responsibilities between general meetings and board varies from company to company. Distributions are also governed by a number of statutory provisions. A company may not make a distribution except out of profits available for that purpose (Sections 291, 297 and 299 of the Companies Ordinance). Profits so available are accumulated realised profits (so far as they have not previously been utilised by distribution or capitalisation or the purchase of a company's own shares) less accumulated realised losses and provisions, so far as not previously written off in a reduction or reorganisation of capital.
233. There is an additional restriction on public listed companies. They can make a distribution only while the amount of net assets (after deducting the distribution) is at least equal to the aggregate of called-up capital and undistributable reserves (Sections 290 and 298 of the Companies Ordinance). Further requirements apply to investment and insurance companies.
234. The question of whether any distribution is lawful is to be determined by reference to relevant accounts. These are either the last annual accounts laid before the general meeting or a special set of interim accounts prepared as provided by the Companies Ordinance (Sections 290, 302 and 304-6).

### **DUTIES TO SHAREHOLDERS**

235. Directors should pay particular attention to any decision involving the company's shareholders or prospective shareholders. The law relating to directors' obligations to shareholders is both extensive and complex, and is of great importance. Issues of shares, merger proposals or bid defences are all examples of situations in which directors may become responsible for the accuracy of the contents of documents. Any failure in this area may expose the company and the directors to both civil and criminal penalties under statute and at common law.
236. A director may become personally liable as the agent of an individual shareholder if he or she undertakes to act on the shareholder's behalf-for instance, by offering to find a buyer for his or her shares.

237. A director may also be liable for having made a negligent misstatement as to, for example, the financial strength of the company, to anyone who, with his or her knowledge, may rely on the statement for business purposes and who does so and suffers a loss as a result.
238. If a director makes an incorrect statement of fact with the intention of misleading people or enticing them to give credit to or invest funds in the company, he or she may well incur a criminal liability for fraud as well as a civil liability for deceit. In addition, Section 3 of the Protection of Investors Ordinance makes it a criminal offence by any fraudulent or reckless misrepresentation to induce another person to enter into an agreement for “acquiring or disposing of ..... or underwriting securities”. This Section must be considered carefully before a company makes any approaches to other persons which could be seen as an invitation to invest, or to dispose of securities. In the context of a prospectus or listing particulars a director may be liable to compensate anyone who suffers loss if these are untrue or misleading.
239. Note that there are various matters which may require voting by poll in the Listing Rules and it is necessary to refer to the Listing Rules to ensure that voting is carried out in compliance therewith.

### **DIRECTORS’ POWERS TO ISSUE SHARES**

240. Formerly, directors had the power to issue shares up to the limit of the company’s authorised capital and it was only when that authorised capital was to be increased that a members’ resolution was needed. These powers were limited by the Companies Ordinance.
241. The present position is that Sections 140-1 of the Companies Ordinance prohibit directors from allotting shares unless so approved by the company in general meeting or unless the allotment is made under an offer made pro rata to the members (such as a rights issue). Such authority can be given for a specific one-off issue, or given generally and may be given subject to conditions. The approval will continue in force only until the next annual general meeting (or the time when the next AGM should be held), although if the approval allows, the allotment itself can be made thereafter if the offer, agreement or option to acquire shares was made within the approval time. A copy of the approving resolution must be filed with the Registrar of Companies within 15 days.
242. Exempt from the above controls are subscribers’ shares taken on formation.

## SHAREHOLDERS' PRE-EMPTION RIGHTS

243. Sections 140-1 of the Companies Ordinance in effect give majority shareholders the right to maintain their proportion of a company's shares when further shares are offered. Minority shareholders do not have the power to prevent the majority shareholders passing an ordinary resolution approving an allotment to be made otherwise than on a pro rata basis.

## TAKEOVERS AND MERGERS

244. A wise board will always bear in mind the possibility that its company may be the subject of a takeover bid and should have a contingency plan for managing such an event (e.g. by assigning responsibility for different actions to different individuals). It is better to work out this sort of detail in advance in order to leave the board free to consider the issues of principle that a bid raises.
245. The main rules governing takeovers and mergers of public companies are not all statutory. Reference must be made to the Hong Kong Code on Takeovers and Mergers ("the Code") and to the requirements of the HKEx. Perhaps the most important principles of the Code are that no relevant information should be withheld from shareholders and that all shareholders should be treated equally. They should be given sufficient evidence, facts and opinions upon which to make an informed judgement and sufficient time within which to do so. Where the board knows of an offer, or a pending offer, it should, in the interests of shareholders, seek competent independent advice at an early stage. Indeed this latter step must be the safest and best course in any takeover bid or amalgamation situation, and the machinery for doing it should form part of the contingency plan referred to above.

### "Dawn Raids" and "Concert Parties"

246. A company seeking to acquire a public company will usually try to build up a substantial stake in its shares before a full bid is launched. The important thing is for the board and the shareholders of the target company to be aware of what is going on so that necessary decisions can be taken. Formerly, this could be frustrated if a potential bidder made a sudden swoop on the market and acquired a substantial stake. A bidder's ability to mount such a "dawn raid" has been restricted by the Code. Moreover, the Securities and Futures Ordinance is designed to reveal the build up of secret stakes in public companies whether listed or not. Disclosure must be made within three business days to the company and the HKEx of all known interests in relevant share capital when those interests first exceed 5% of the issued capital of the company and of any subsequent changes of 1% or more. An "interest" includes interests by virtue of a purchase contract or option, arrangements which may confer a right to exercise or control the exercise of voting power, or an obligation to take an interest in shares or a right to call for delivery of shares.

247. The provisions also deal with “concert parties”, i.e. a number of parties acting in concert but without a formal connection. Members of such a group may each acquire less than the notifiable interest in shares of the company in order to avoid the disclosure requirements. The provisions of the Ordinance therefore have the effect of attributing to each member of a party acting in concert the interests of the other members, and requiring those interests to be taken into account by the member in determining whether he or she is subject to an obligation to notify.
248. Listed companies have the power to require disclosure of the persons interested in their shares, and can apply to the courts to freeze the voting powers and transferability of shares if the identity of such persons has not been disclosed. The company must keep a register of all interests disclosed to it, and failure so to do can result in the directors being guilty of an offence.

### ***DUTIES – CAPITAL AND THE MAINTENANCE OF CAPITAL***

249. The capital of a business is the amount that would be due on the winding up of the company to its proprietors, after the lawful claims of all the other parties associated with the business have been met. The doctrine of maintenance of capital is very important for limited companies, which must neither return shareholders’ own funds to them as if they were a distribution of profits nor arbitrarily diminish the fund from which creditors may legitimately expect to be paid. Maintenance of capital does not mean that a company is not permitted to make losses, nor that it must necessarily make good a previous year’s losses before it can make a distribution of a later year’s profits. It does mean, however, that a company and its directors must make a clear distinction between what is distributable profit arising from the use of capital and what is capital itself and therefore not distributable. This distinction underlies many of the legal provisions relating to a company’s capital.

### **PAYMENT FOR SHARES IN LISTED COMPANIES**

250. In an offer to the public, a listed company may not allot any shares unless the amount stated in the prospectus as the minimum amount (in the opinion of the directors) needed to be raised to satisfy the purpose of the issue has been received in subscriptions.

### **PURCHASE AND REDEMPTION OF A COMPANY’S OWN SHARES**

251. The general rule is that a company may not purchase its own shares or issue redeemable ordinary shares, as this might result in a reduction in the company’s funds available for the creditors. However, the Companies Ordinance provides exceptions to this general rule subject to certain conditions designed to protect creditors and shareholders. It is now permitted to do both these things, so long as they are in accordance with the provisions of the Companies Ordinance.

252. The relevant provisions are contained in Section 234 of the Companies Ordinance.
253. All companies may now issue redeemable ordinary shares but they must always ensure that some of the company's issued shares are non-redeemable.
254. All companies may also, subject to certain rules, purchase their own shares if they do so out of the proceeds of a special share issue, or out of distributable profits and provided that they always leave some member of the company holding non-redeemable shares.
255. A company may also, subject to certain rules, use capital to redeem or purchase its own shares to the extent that it cannot do so out of distributable profits or the proceeds of a new issue. The procedure is subject to a number of procedural requirements, principally to safeguard creditors. The directors must first make a statutory declaration as to the company's solvency and viability over the coming year, confirmed by reference to reports from the auditors. The members must then approve the scheme by special resolution. The shares which are the subject of the resolution may not be voted.
256. It is an offence for directors to make the statutory declaration without having reasonable grounds for the opinion expressed in it.
257. These powers to acquire their own equity are of particular value to companies by providing a way of buying out a shareholder, whether on retirement or by reason of dissatisfaction or dispute.
258. Share repurchases by public companies are additionally regulated by the Code on Share Repurchases (administered by the Committee on Takeovers and Mergers) and the HKEx's Listing Rules.
259. Listed companies repurchasing their own shares must have regard to the Code on Share Re-purchases published by the Securities and Futures Commission, as well as applicable Listing Rule provisions.

### **FINANCIAL ASSISTANCE FOR THE ACQUISITION OF A COMPANY'S SHARES**

260. It is in principle also unlawful for any company to give financial assistance for the acquisition of its own shares, or those of its holding company. Financial assistance is defined very widely in the Companies Ordinance and there are a number of ways in which a company may be deemed to have given such assistance. Therefore, any transaction which could be seen as having this effect should be approached with caution and in the light of a careful study of Sections 205-7, 274-5, 277-282 and 286-289 of the Companies Ordinance.

261. Generally, companies will not be found to have provided financial assistance if:
- The transaction is in good faith, in the interests of the company; or
  - The transaction is an incidental part of some larger purpose of the company or is not specifically designed for the purpose of giving assistance to the acquisition of shares or reduction of capital.
262. There are a number of other exceptions to the general rule contained in the Ordinance including:
- Where the company's business includes the lending of money and a loan in the ordinary course of that business is used by a person who subsequently acquires shares in the company;
  - Where the assistance is given in good faith in the interests of the company, for the purposes of some kind of employees' share scheme;
  - Where the company is allotting bonus shares, paying a dividend which is used by the payee to purchase more of the company's shares, or reducing its capital as approved by the court;
  - Where the company loans money to its employees (which must not include a director or a person connected to a director) to enable them to purchase shares in the company/holding company to hold them as beneficial owner.

In the first two cases above, an additional requirement is that the assistance so given must be given out of distributable profits or so as not to reduce the company's net assets.

263. There are rules for companies set out in Sections 283-289 of the Companies Ordinance. Essentially, a company may in general provide financial assistance for the purchase of its shares for any purpose but it must be approved by one of the three procedures prescribed in the said Sections. The assistance must come out of distributable profits or not reduce net assets, and there are detailed rules governing the exercise of this power on the filing of statutory declarations by a majority of the directors as to the company's solvency.

### **OTHER WAYS TO REDUCE CAPITAL**

264. In certain limited circumstances, a company may reduce its capital by passing a special resolution and then applying to the court to have the reduction confirmed (Sections 210-211 of the Companies Ordinance).

## **DUTIES IN RESPECT OF CREDITORS AND INSOLVENCY**

### **DIRECTORS' LIABILITY TO CREDITORS**

265. In normal circumstances the directors will not be personally liable to the creditors of the company provided they are not contracting on their own account. A director should make it clear that he or she is contracting on behalf of the company and not on his or her own account in order to avoid doubt. This is particularly important when a director signs a document such as a cheque or any order for goods or money on behalf of the company. Failure to include the name of the company on such a document will, in addition to a fine, result in the director being personally liable for the money or the price of the goods unless duly paid by the company (Section 26 of the Bills of Exchange Ordinance).
266. However, when the company is insolvent, the directors' paramount duty is to the interests of creditors above the interests of the company and its shareholders.

### **DUTIES IN THE COURSE OF WINDING UP**

267. A difficult problem connected with insolvency is to decide when a company is insolvent. It is particularly important for directors to get this right; the personal consequences of failing to do so may be catastrophic. Section 275 of the WUMPO makes them personally liable to make contributions to the assets of the company if, in the course of the winding up, it appears that they were knowingly a party to business being carried on with the intention of defrauding creditors or for any fraudulent purpose. Directors may also face criminal penalties for such fraudulent trading (see para 279 below).
268. A company is regarded as insolvent if it is unable to pay its debts as they fall due. A director of a company in financial difficulties who suspects that it may be, or may become, insolvent, or that a particular decision may cast doubt on a company's prospects of solvency in the future, should immediately requisition a board meeting or call one if the company's Articles empower a single director to do so, to acquaint all the directors with his or her suspicions. The board should seek professional advice, starting with the company's auditors, who are likely to be the advisers most conversant with the company's accounting records and financial affairs.
269. If the suspicions are confirmed, the company will need immediate advice from both accountants and lawyers with the necessary expertise as insolvency practitioners to determine whether any remedial measures short of liquidation are possible.
270. If remedial measures short of winding up are not possible the director should ensure that the company ceases to trade.



271. If, in the course of a company's winding up, it appears that any officer, past or present, has misapplied or retained, or become liable or accountable for, any money or property of the company, or is guilty of a misfeasance or breach of duty in relation to the company, the official receiver, liquidator, any creditor or a contributory – e.g. a shareholder-can apply to the court for the conduct of that director to be investigated (Section 276 of the WUMPO). The court has power, after such investigation, to order payments to the company by way of restitution or compensation. Misfeasance has been defined in this context as any breach of duty involving a misapplication or wrongful retention of company monies.

### **DEFRAUDING CREDITORS AND PREFERENCES**

272. If an officer of the company, with the intention of defrauding its creditors, has made or caused any gift, transfer or charge of, or the levying of execution against, the property of the company or concealed or removed any part of the property of the company after, or within two months before, any unsatisfied judgment or order for payment against the company, and the company is subsequently wound up, he or she is guilty of an offence and is liable to a fine and imprisonment. There are also provisions for the court or liquidator to refer the matter to the Secretary for Justice for him or her to institute proceedings against the officer who has committed an offence.

273. There are a number of other offences (such as falsifying records, concealing debts or not co-operating with the liquidator) that can be committed by a past or present officer of a company (including a shadow director) in the course of or during the period of twelve months prior to winding up unless, in the case of most such offences, and depending upon the particular one, he or she can prove that he or she had no intent to defraud or conceal the state of affairs of the company or defeat the law.

274. The Companies Ordinance contains a number of provisions aimed at avoiding disposals of the assets of a company which should have been preserved for the company's creditors in its insolvency. The following paragraphs contain a very brief summary of those provisions.

275. Under Section 266(1) of the WUMPO certain conveyances, mortgages, deliveries of goods, payments, executions or other acts relating to a company's property can be deemed a fraudulent preference of the company's creditors and hence invalid. The test is whether any such transaction would have been a fraudulent preference if committed by an individual in his or her bankruptcy. For example, if a company is unable to pay all its debts and makes a payment to one of its creditors in preference to others, this may constitute a fraudulent preference. However, if such payment is made as a result of pressure from a creditor (for example-the threat of legal proceedings), it is less likely to constitute a fraudulent preference. All the surrounding circumstances of the payment will be relevant.

276. A floating charge on the undertaking or property of a company created within 12 months before the winding up is invalid unless it is proved that, immediately after the creation of the charge, the company was solvent. It will also be valid to the extent of any cash paid at the time to the company in consideration for the charge (Section 267 of the WUMPO). This Section is intended to prevent insolvent companies from creating floating charges to secure past debts and so prefer a particular creditor to the detriment of others.

## ***DUTIES – HOW SHOULD THEY BE PERFORMED?***

### **STANDARD OF SKILL AND CARE**

277. The standards of skill and care which directors must bring to their duties and the manner in which these duties are to be performed was considered in the English case *Re City Equitable Fire Insurance Company Ltd.* (1925), and can be summarized as follows:

- A director must exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take in looking after his or her own interests in the particular circumstances but he or she needs not exhibit, in the performance of his or her duties, a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience;
- His or her duties are of an intermittent nature to be performed at periodical board meetings, which he or she ought to attend when reasonably able to do so;
- In respect of duties that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in relying on that official to perform such duties honestly.

277A. Under the Companies Ordinance, Section 465 clarifies the director's duty of care and skill as follows:

### **Duty to exercise reasonable care, skill and diligence**

- (1) A director of a company must exercise reasonable care, skill and diligence.
- (2) Reasonable care, skill and diligence mean the care, skill and diligence that would be exercised by a reasonably diligent person with:
  - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

- (b) the general knowledge, skill and experience that the director has.
- (3) The duty specified in subsection (1) is owed by a director of a company to the company.
- (4) The duty specified in subsection (1) has effect in place of the common law rules and equitable principles as regards the duty to exercise reasonable care, skill and diligence, owed by a director of a company to the company.
- (5) This Section applies to a shadow director as it applies to a director.
- (6) For the purposes of subsection (5), a body corporate is not to be regarded as a shadow director of any of its subsidiaries by reason only that the directors, or a majority of the directors, of the subsidiary are accustomed to act in accordance with its direction or instructions.

277B. To perform professionally, a director needs to strengthen capability in the duty of care in general and the duty of skill in particular. The duty of care calls for careful thought, analysis, judgment and other individual qualities. The duty of skill calls for skill-sets that apply to the various requirements in legal and regulatory compliance, strategic corporate development, board development and fulfilment of specific board roles. All these qualities and skill-sets can be enhanced through engaging in continuing professional development.

278. The Companies Registry has issued some non-statutory guideline for directors on this issue. In addition, the CG Code requires that:

- (1) Newly appointed directors should receive a comprehensive and tailored induction on the first occasion of his or her appointment, and subsequent professional development as necessary to ensure that he or she has a proper understanding of the operations and business of the company and that he or she is fully aware of his or her responsibilities under statute and common law, the Listing Rules, applicable legal requirements and other regulatory requirements and the business and governance policies of the company.
- (2) It is a recommended best practice of the CG Code that all directors should participate in a programme of continuous professional development to develop and refresh their knowledge and skills to help ensure that their contribution to the board remains informed and relevant. Listed companies should be responsible for arranging and funding a suitable development programme.

- (3) The functions of non-executive directors should include but should not be limited to:
- (a) bringing independent judgement to bear on issues of strategy, performance, resources, key appointments and standards of conduct;
  - (b) taking the lead where potential conflicts of interests arise; and
  - (c) serving on the audit, remuneration, nomination and other governance committees.
- (4) Every director should ensure that he or she can give sufficient time and attention to the affairs of the company and should not accept the appointment if he or she cannot do so.
- (5) Directors must comply with their obligations under the Model Code on Securities Transactions by Directors of Listed Companies set out in the Listing Rules.

It is also recommended that directors disclose to the company at the time of appointment, and periodically, the number and nature of offices held in public companies or organisations and an indication of the time involved.

### **“KNOWINGLY A PARTY” TO FRAUDULENT TRADING**

279. Mention should also be made of “fraudulent trading” which, if proved, carries criminal as well as civil sanctions. Any person (not necessarily a director) knowingly a party to the “fraudulent” carrying on of a company’s business is liable. The provisions only apply on a winding up and it must be proved that the business was carried on with intent to defraud creditors. This requires a high standard of proof. Nonetheless, the courts have indicated that the requisite intent to defraud might be evidenced by the incurring of a debt which the directors knew the company had no reasonable prospect of paying when it fell due or within a reasonable time thereafter. If, however, the directors genuinely believe that the company’s business will pick up in the future, they may be entitled to incur credit to get the company through a bad patch, even if there are no immediate prospects of the company meeting all its liabilities when they become due.

### **UNDER A SERVICE CONTRACT**

280. Where a director has accepted an executive function, his or her obligations in this regard are in addition to any duties which he or she may have as a director. A service contract for an executive director can, and often does, include specific express obligations imposing a degree of skill that is higher than that which would otherwise be implied at law.

## **INDEMNITY AND RELIEF FROM LIABILITY DUTIES**

### **INDEMNITY**

281. The law, quite properly, does not make it easy for directors to be indemnified by their company if they have failed in any duty owed to it. A company cannot make a prior agreement with a company's officers (or auditors) to indemnify them against or exempt them from any liability arising from any negligence, default, breach of duty or breach of trust in relation to the company (an "officer" includes a director, manager or secretary). Any provision purporting to have this effect, whether in the Articles, in any contract with the company or otherwise, is void (Section 468 of the Companies Ordinance). Section 468 does not appear to prevent a company making a prior agreement to indemnify a director against any liability to a third party arising from his or her directorship provided that the breach of duty to the third party is not, at the same time, a breach of the director's duty to the company.
282. A company may, however, (under Section 468) make a prior agreement to indemnify its officers or auditors against the costs incurred by them in defending any proceedings, civil or criminal. Section 468 also enables a company to purchase directors' and officers' liability insurance for the benefit of its directors and officers.

The CG Code has made it a Code Provision that a listed company should arrange appropriate insurance cover in respect of legal action against its directors.

### **RELIEF**

283. A company may also make a valid prior agreement to indemnify an officer or auditor if relief is given by the court under Sections 902-4 of the Companies Ordinance. Under this provision, if proceedings are taken or anticipated against an officer or auditor for negligence, default, breach of duty or breach of trust, the court may grant relief either wholly or partly on such terms as it thinks fit. Relief can be granted only if the court finds that:
- The director has acted honestly; and
  - Reasonably; and
  - That, having regard to all the circumstances, including those connected with his or her appointment, he or she ought fairly to be excused.
284. It is important to note that all the conditions must be satisfied. For example, a director will not obtain relief if he or she acts honestly but fails to obtain legal advice where a reasonable person would have done so. Relief is less likely to be granted if the director concerned receives substantial remuneration.

## **THE COMPANY'S GENERAL LEGAL OBLIGATIONS**

### **GENERAL**

285. As the company's officers are its mind and will, directors must ensure that the company complies with its general legal obligations. These are, for good reason, wide-ranging and complex. They are also becoming the subject of considerable public attention in Hong Kong, particularly in the context of the health and safety of employees and consumers and protection of the environment.
286. A company, as a corporation, can commit an unlawful act only through the agency of natural persons – directors or employees. The liability of both these parties and the degree to which the company may be involved differs depending on whether the unlawful act concerned is a tort or a criminal offence, or on how it is treated if, as can often happen, the same act is both. It also differs according to the degree of criminal intention that is required to be proved to establish whether an offence has been committed.

### **IN TORT**

287. A tort is a wrong done involving a breach of duty which entitles a person suffering loss or damage to sue for compensation. Most motor accident claims, for instance, are based on the tort of negligence. In the context of a limited liability company it is likely that three parties may be involved in the commission of a tort: the company itself, the directors who authorised the tortious action and the employee who physically committed it. Under the doctrine of vicarious liability a company will normally be liable for employees' torts committed in the course of their employment.
288. For a director to be liable for a corporate tort involving active commission, some measure of participation in physically committing the tort or directing or procuring it is required. The bare fact that an individual is a director is not of itself sufficient. At the same time a director cannot escape liability on the ground that he or she had no tortious intention unless the tort concerned requires proof of such intention. The position of directors involved in a corporate tort based on omission (e.g. negligence) is less clear but it is safe to assume that directors who fail to ensure that the company acts with due diligence towards third parties, where a duty to do so is owed to those parties, may thereby expose themselves to an action from a third party injured through a corporate default. In these circumstances a director may also be liable to the company by way of indemnity because his or her negligence may be a breach of a director's duties of skill and care, or of a service contract.

## CRIMINAL OFFENCES

### I. Requiring proof of intention

289. It has been established since 1944 that a company can commit a crime requiring proof of criminal intention if its “controlling officers”, including senior managers as well as directors, participate in the commission of an offence. The state of mind of such officers, who may also be guilty of the offence, is imputed to the company. When The Herald of Free Enterprise sank off the Zeebrugge coast in March 1987, causing the death of 192 passengers and crew, manslaughter charges were brought against P&O European Ferries and some of its directors and employees. The subsequent criminal trial collapsed in October 1990 when the judge directed the jury to return not guilty verdicts. That case highlighted the difficulty of indicting a company for corporate manslaughter because the prosecution had to prove that at least one of the company’s directors was grossly negligent about an obvious risk of death or injury. Consequently the degree of negligence has to be of a very high order. The knowledge of several partly culpable directors cannot be added together. It is therefore difficult to find one director out of a group who had knowledge of all the relevant facts such that he or she could be found grossly negligent.
290. By contrast, in late 1994 a director of a company in England and his company were both convicted on charges of manslaughter following the death of four teenagers who drowned in Lyme Bay in March 1993 while taking part in a canoe expedition. In this case written warnings about inadequate safety procedures were ignored. The conviction serves as an important reminder to directors to heed and, if necessary, act on specific warnings which they receive.
291. Corporate manslaughter charges were also brought against a company and one of its directors in England in January 1995 following the sinking of a Cornish fishing boat in 1991, in which six people died. It seems unlikely, however, that prosecutions will be confined to tragedies at sea. Health and safety at work, transport and the environment all seem fertile areas for prosecutions in the future. Hong Kong’s first manslaughter trial resulted from the death of 12 workers at a construction site in Java Road, North Point in June 1993. In view of a trend, both legal and social, to attribute blame in the wake of a disaster, directors should take particular care to ensure full compliance with their statutory and fiduciary responsibilities. Delegation of these responsibilities to others will not necessarily suffice to relieve directors from liability.

## II. Not involving proof of intention

292. Many statutes besides the Companies Ordinance and the legislation associated with it affect a director's work. These statutes impose a parallel liability for offences committed by a company on a director who consents to or connives at an offence or, if the offence is one of omission and not commission, or does not require proof of criminal intention (and most do not), on a director to whose neglect it is attributable. Most statutes protecting consumers, employees or investors, or otherwise regulating the economy or protecting the environment, contain a provision to this effect.
293. Most of the statutes creating offences of strict liability also provide for statutory defences based on the concept of "due diligence", or "act or default of another person". It appears, from the case of Tesco Supermarkets Ltd v. Nattrass (1971), that it may not be easy for a company, and therefore for its board, to escape liability by invoking these defences if the issue involved is of sufficient strategic importance. In the case referred to (which involved a contravention of the Trade Descriptions Act 1968) the company successfully contested liability but was only able to do so by demonstrating that there was a company policy created by the board and an adequate and appropriate system to ensure that the policy was put into practice. In these circumstances, it was held that the contravention was not the act of the company nor the directors but the act of "another person", in this case the store manager who was actually responsible.

### STATUTORY OFFENCE WITH CIVIL LIABILITY

- 293A. Under the Securities and Futures (Amendment) Ordinance 2012 (Amendment Ordinance)(which introduces a new Part XIVA of the Securities and Futures Ordinance (SFO), a statutory disclosure regime has been established whereby listed corporations will be required to disclose price sensitive information (PSI) in a timely manner, backed by civil sanctions for non-disclosure of PSI. The Securities and Futures Commission (SFC) is empowered to directly institute proceedings before the Market Misconduct Tribunal (MMT) to enforce PSI disclosure requirement.
- (1) Under the Amendment Ordinance, a Hong Kong-listed corporation (whether primary or secondary listed) must disclose PSI as soon as reasonably practicable after such information has come to its knowledge. If the corporation breaches these disclosure requirements, an officer (meaning a director, manager or secretary of, or any other person involved in the management of, the corporation) will also be in breach if:
- (a) the corporation's breach is a result of his or her intentional, reckless or negligent conduct; or
  - (b) he or she has not taken all reasonable measures to ensure that proper safeguards exist to prevent the breach.



- (2) The term “inside information” in Part XIVA of the SFO is the same as that of “relevant information” used in Section 245 in Part XIII of the SFO in connection with insider dealing. The MMT may impose the following civil sanctions on Hong Kong-listed corporations and their officers:
- (a) disqualification of the officer from being a director or otherwise involved in the management of a listed corporation for up to five years;
  - (b) a “cold shoulder” order on the officer depriving such officer access to market facilities for up to five years;
  - (c) a “cease and desist” order on the listed corporation or officer (i.e., an order not to breach the statutory disclosure requirements again);
  - (d) a regulatory fine up to HK\$8 million on the listed corporation, each of the directors and/or the chief executive, respectively;
  - (e) a recommendation to any body of which the officer is a member to take disciplinary action against him or her;
  - (f) payment of costs of the civil inquiry and/or the SFC investigation by the listed corporation or officer;
  - (g) such order as is necessary to ensure that the listed corporation takes appropriate action to prevent a similar breach of the disclosure requirement.

This includes:

- (i) ordering an officer to undergo training;
  - (ii) ordering a listed corporation to appoint an independent professional adviser to review its compliance procedure; and
  - (iii) ordering a listed corporation to appoint an independent professional adviser to advise on compliance matters.
- (3) In addition, any party affected by a breach of such statutory disclosure requirements by the corporation or its officers has a statutory civil right of action to recover compensation for any pecuniary loss sustained as a result of the breach.