Directors’ Position in Troubled Companies

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Foreword

• This seminar will use case studies to discuss the director’s position when the companies they serve, whether listed or private, are in troubles. This may be because of insolvency, or where the shareholders are at loggerheads or if the company is facing regulatory investigations.

• Recent developments in company and insolvency law, as well as the requirements of regulatory compliance, seem to be placing an ever higher burden on the company directors. The seminar will discuss how the directors should react when the company is in crisis. It should be of relevance to both executive and independent directors.

• Senior officers are often in similar position as directors. Their concerns will also be addressed.
Outline

1. The scope of a director’s duties
2. Actions that can be taken by minority shareholders
3. Actions that can be taken by regulators
4. The risks faced by directors of insolvent companies
THE SCOPE OF A DIRECTOR’S DUTIES
1. The Scope of a Director’s Duties

- A director’s duties to the company are classified into two broad categories:
  - Fiduciary duties
  - Duty of care

- Fiduciary Duties:
  - duty to act in good faith in the interests of the company;
  - duty to exercise powers for proper purposes;
  - duty to avoid conflicts of interests;
  - duty not to make secret profits; and

- Statutory duty of care:
  - duty to exercise due care, skill and diligence
  - see section 465 of the Companies Ordinance (Cap 622)
Duty to exercise reasonable care, skill and diligence

section 465 of the Companies Ordinance (Cap 622)

(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.
Regal (Hastings) Ltd v Gulliver (1942)

Facts:-

1. Regal proposed to establish a subsidiary (Amalgamated) with capital of £2,000 for the purpose of acquiring leases of two cinemas.
2. In the negotiations for the acquisition of the lease, the landlord required the directors to provide guarantees for the payment of the rent until the issued capital of Regal reached £5,000.
3. The directors were unwilling to do so and instead subscribed for shares in the subsidiary in order for Regal’s issued capital to amount to £5,000.
4. The directors subsequently sold their shares in Amalgamated for a profit.
5. The shares in Regal were also sold to other purchasers, and the new board caused Regal to bring an action against the directors for an account of profits.
Regal (Hastings) Ltd v Gulliver (cont’d)

House of Lords:-

1. The directors were liable to account on the basis that they had obtained the shares (and the subsequent profits) only by reason of the fact that they were directors of Regal and in the course of execution of that office.
2. The knowledge and opportunity which enabled them to make the gain came to the directors solely by reason of their being directors of Regal.
3. Although Regal was not in a position to subscribe for the further shares in Amalgamated, but the directors’ liability to account can arise notwithstanding that the company could not have taken advantage of the opportunity and notwithstanding that the directors acted bona fide and the company itself suffered no loss.
Negligence

Examples of action against directors for negligence:

- **Chingtung Futures Ltd (In Liquidation) v Lai Cheuk Kwan Arthur & Ors [1992] 2 HKC 637**
  - Director failed to monitor credit risk of a futures trading account. Customer defaulted causing substantial loss to the company.

  - Director negligently filled in insurance proposal form resulting in insurance policy being avoided, company failed to get compensation for a factory destroyed by fire.
Weavering Capital (UK) Ltd v Peterson [2012] EWHC 1480 (Ch)

- Fraud, breach of fiduciary duty
- Negligence

Liquidators

WCUK (in liq)
- Manager and Adviser of Macro

D1
- Director
- Control (father and brother nominees)

D2
- Director

D9
- Director

D10
- Senior Employee

CE/MD

Investors

CE/MD

WCF

OTC transactions

Macro (in liq)
- Public fund

$ Public fund

Swaps

FRAs

Advice and Manage

ONC Lawyers
Weavering Capital (UK) Ltd. v. Peterson (cont’d)

WCUK set up and managed a public fund called “Macro”. Macro’s Offering Memorandum set out its objectives and strategy, which include:

- To effect capital appreciation by producing long-term risk adjusted returns by a portfolio of “a balanced and diversified risk profile”.
- No more than 20% of the value of the Gross Assets of the Company is exposed to the creditworthiness or solvency of any one counterparty.
- Instruments for investment would be predominantly exchange-traded (as opposed to OTC).
Weavering Capital (UK) Ltd. v. Peterson (cont’d)

- Facts:
  - D1 Mr. Magnus Peterson – CE and MD of WCUK
  - D2 Mrs. Amanda Peterson – Director, D1’s wife, herself an experienced trader
  - D9 Mr. Dabhia – a 27-year-old director with duties including marketing and customer relationship
  - D10 Mr. Platt – a senior employee responsible for compliance and administration
Weavering Capital (UK) Ltd. v. Peterson (cont’d)

• From the beginning, D1 caused Macro to enter into OTC transactions with another (non-public) fund called WCF (set up by D1 with father and brother being nominees) to cover up losses of Macro incurred in exchange-traded transactions.
• In fact, many such transactions were simply shams to make the books of Macro look good.
• In any event, Macro’s risk was pre-dominantly skewed to the creditworthiness of WCF (which had little assets).
• Macro appeared to be making steady positive return until it failed to meet redemption requests in the fall of 2008.
Weavering Capital (UK) Ltd. v. Peterson (cont’d)

• Macro went into liquidation and its liquidators sued WCUK for breaches of the Investment Advisory Agreement, breaches of fiduciary duty, negligence etc.
• The Investment Agreement provided that:
  ➢ WCUK would indemnify Macro in respect of all losses and liabilities suffered or sustained by Macro resulting or arising in any way from the fraud, negligence or wilful default of WCUK.
  ➢ Liquidators of WCUK admitted the claim and then sought reimbursement from the defendants on various grounds including: tort of deceit, breach of fiduciary duties, negligence and dishonest assistance.
Weavering Capital (UK) Ltd. v. Peterson (cont’d)

- D1 held liable for breach of fiduciary duties, negligence, deceit.

- D2 defended that her role in WCUK was confined to exchange traded transactions. The OTC transactions were not carried out by her. And that she was justified in delegating the compliance duties to outside professionals (including auditors EY and the custodian of Macro, PNC Global), other directors and senior employees.
Director (D2)

- The court took the following factors into account to hold her liable in negligence:
  - she herself was an experienced trader;
  - she was highly paid;
  - the company was relatively small so that everyone knew what everyone else was doing;
  - she knew of and approved at least some irregular OTC transactions;
  - she is to be judged against what a reasonable director should have done in her situation, not what she could have done, i.e. subjective factor such as D1 being her husband is irrelevant.
  - **the test** is “whether D2’s conduct was that of a reasonable director of a hedge fund management company in her position who had her experience, actual knowledge and intelligence, and whether she had acquired sufficient knowledge of WCUK’s business to discharge her duties”.


Director (D9)

- The 27-year-old director.
- His duties include attending meetings with investors and prospective investors to discuss Macro's strategy, holdings and performance, sending out marketing materials and due diligence questionnaires of Macro and dealing with queries from investors.
- Many of his communications with investors concerning the OTC transactions were found to be false and misleading.
- The defence that he was merely passing on the messages of D1 was not sustainable.
  ➢ As director, he failed in his duties by not acquiring sufficient knowledge and understanding of WCUK’s business and the details and propriety of the OTC transactions; and taking care in his communications with investors.
Senior employee (D10)

- D10 was regarded as D1’s right-hand man and always followed D1’s instructions.
- He sent the trade tickets for the OTC transactions to Macro’s Administrator for valuation, and circulated untrue NAV estimates to the investors.
- His bookkeeping for the OTC transactions was flawed and involved backdating, forging of documents and irregularities in documentation for the OTC transactions.
Senior employee (D10) (cont’d)

Held:

• Even though D10 was not a director and regarded his role as confined to options and futures trading, his duties to WCUK were held to be fiduciary in nature.
• He was highly paid and was entrusted to safeguard the cash and investments under WCUK’s management.
• Therefore, he owed a duty to conduct WCUK’s business with due care, skill and diligence.
• His compliance duty was also incorporated in his employment contract.
• In blindly following D1’s instructions in operating the OTC transactions without questions, D10 was held to be negligent.
ACTIONS THAT CAN BE TAKEN BY MINORITY SHAREHOLDERS
2. Actions that can be taken by minority shareholders

Unfair prejudice / winding-up petition: -

• Where the majority shareholders in control of the board of directors have conducted the affairs of the company in a manner unfairly prejudicial to the minority shareholders

• Remedies:
  ➢ Winding-up
  ➢ Buy-out order
  ➢ Compensation

Derivative action:-

• Minority shareholders may take derivative action against delinquent directors on behalf of the company

• (form of action: XX suing on behalf of all shareholders of the Company except YY)

• All recoveries go to the company
Re C F Booth Limited [2017] EWHC 457 (Ch)

Facts:-

- C F Booth Limited ("the Company") was incorporated in 1949 to carry on the family scrap metal business established by Clarence Booth in 1920.
- The current shareholders of the Company are all descended from Clarence. The petitioners own 27% of the Company between them. The respondents own 65% and four of them are directors of the Company ("the Booth Directors").
- The petitioners complained that the affairs of the Company have been conducted to their unfair prejudice because the Booth Directors have taken excessive remuneration whilst causing the Company to pursue a policy of not paying dividends.
- The business of the Company was successful and profitable. Substantial dividends were paid every year from incorporation until 1985. In 1986, the Company suffered a loss and no dividend was paid. Despite returning to healthy profitability between 1987 and 2013, no dividend was ever again declared.
Re C F Booth Limited (cont’d)

Findings:

- **Excessive remuneration**
  - Relying on an expert report → the Booth Directors’ remuneration far exceeded the amount that reasonable directors acting in the best interest of the company could have thought fair for the work they undertook: *Irvine v Irvine* [2007] 1 BCLC 349.

- **Dividend policy**
  - The directors have a discretion whether to recommend a distribution of profits.
  - The test is whether an intelligent and honest man in the position of a director of the company in question could in all the circumstances have reasonably believed that the non-payment of dividends was appropriate.
Re C F Booth Limited (cont’d)

• **Dividend policy**
  - The Booth Directors claimed that all spare cash was needed for the business.
  - There would have been sufficient distributable profit if the Booth Directors were not excessively remunerated.
  - Further, the Court observed that the no-dividend policy was intended to help the Booth Directors acquire the minority shares at a favorable price, which made the shares less attractive.
  - The Booth Directors thus breached their duties
    - to use the power to recommend a dividend for the purposes for which the power was conferred;
    - to make the recommendation they considered most likely to promote the company’s success for the benefit of its members as a whole; and
    - to exercise independent judgment

• **Order:** The Booth Directors to buy out the petitioning minority shareholders at a valuation that would reflect the unfair prejudice suffered by the petitioners.
Re C F Booth Limited (cont’d)

Directions on valuation:

• Date of valuation of shares: the respondents resisted the petition on unjustified grounds → the petitioners had been locked into a loss-making company which they had been entitled to leave → the shares be valued on the petition date

• Basis of valuation:
  ➢ The excessive remuneration for 6 years prior to the petition be added back to the company’s balance sheet
  ➢ The company was not profitable and there was no evidence that it could have been sold on a going concern → midpoint between break-up value and going concern value

• One-third discount to reflect the minority shareholding
Choi Chi Wai v Cheng Ka Shing and Others HCMP 729/2012

Facts:-

• Hong Kong Agriculture Special Zone Limited (“the Company”) was incorporated on 19 June 2006.
• The Company has always been equally owned by three shareholders, namely Mr. Choi Chi Wai (“Mr. Choi”), Mr. Cheng Ka Shing (“Mr. Cheng”) and Mr. Lee Pak Kee (“Mr. Lee”).
• They are all experienced businessmen engaging in farming business in Hong Kong. Upon incorporation, they were appointed as directors of the Company.
**Choi Chi Wai (cont’d)**

Facts: -

- On 31 August 2007, the China Chamber of Commerce of Foodstuffs and Native Produce (中國食品土畜進出口商會) (“CCCFNP”) announced that it would appoint a Hong Kong company to be its third authorized agent, and invited companies with the relevant experience and financial capability to submit their applications.

- Mr. Cheng and Mr. Lee were not willing to use the Company to pursue the application. Nonetheless, they agreed to let Mr. Choi give it a try and put in an application in the name of the Company to CCCFNP.

- On 22 October 2007, the Ministry of Commerce announced that the CCCFNP decided to appoint the Company as the third authorized agent to import and sell live pigs from the Mainland into Hong Kong.

- Between 22 October 2007 and 28 November 2007, Mr. Choi, with the assistance of his family members managed to establish the entire network and business model required for the agency business. Since then, the Company has been carrying on its agency business using the same business model established by Mr. Choi.
**Choi Chi Wai (cont’d)**

Facts: -

- During the period from 28 November 2007 to 31 December 2007, the Company was managed and operated by Mr. Choi alone. He was assisted by Mrs. Choi and other family members. Mr. Cheng and Mr. Lee had no involvement in the day-to-day operation of the Company or its business. At the Board of Directors’ meeting on 20 December 2007, Mr. Choi agreed to gradually return the operation of the Company to Mr. Cheng and Mr. Lee from 1 January 2008. At the EGM on 8 March 2008, resolutions were passed by Mr. Cheng and Mr. Lee to remove Mr. Choi as director of the Company.

- Shortly after Mr. Lee and Mr. Cheng had taken control over the Company, they caused the Company to enter into an agreement dated 1 May 2008 with Hong Kong Agriculture Special Zone Management Ltd (“Management Company”). The Management Company was incorporated by 8 individuals of Hong Kong Agriculture Special Zone Development Association (“the Association”). The appointment of the Management Company was made to satisfy the requests of the members of the Association to share the business and profit of the Company.
**Choi Chi Wai (cont’d)**

Facts: -

- In May 2009, it was discovered that the Management Company had overcharged its remuneration. Despite the discovery of the overcharge, Mr. Cheng did not take any step to recover the amount overpaid from the Management Company. Instead, he continued to retain the Management Company. The appointment of the Management Company was only terminated on 15 September 2010, and no step had been taken by the Company to recover the overcharged balance for about 2 years until 27 September 2012. After obtaining default judgment against the Management Company on 7 November 2012, no step was taken to enforce the default judgment.

- On 16 April 2012, Mr. Choi presented an “unfair prejudice” petition, alleging that Mr. Cheng and Mr. Lee have conducted the affairs of the Company in an unfairly prejudicial manner.
Choi Chi Wai (cont’d)

Findings:

- Not fair or equitable for Mr. Cheng and Mr. Lee to exclude Mr. Choi from participating in the management of the Company
  - The Company was formed on the basis of personal relationship involving trust reposed by the shareholders on each other → a *quasi* partnership
- Mr. Cheng and Mr. Lee acted in breach of their fiduciary
  - Misuse of power to appoint the Management Company for the purpose of satisfying the requests of the members of the Association still less to benefit them
- Mr. Cheng and Mr. Lee further breached their fiduciary duties
  - they failed to recover the amount overcharged by the Management Company; rather they retained the Management Company after discovery of the overcharge
  - it was incumbent upon them to protect the interest of the Company by taking all possible steps to recover the amount overcharged
Choi Chi Wai (cont’d)

Findings:

- The remuneration Mr. Cheng and Mr. Lee paid to themselves were excessive
  - the entire modus operandi of the business had been established by Mr. Choi, and after Mr. Cheng and Mr. Lee took control of the Company, Mr. Cheng simply followed the same mode in operating the business
  - adjustment was ordered
- The failure on the part of Mr. Lee and Mr. Cheng to cause the Company to declare any dividends to the shareholders was both unfair and prejudicial to the interests of Mr. Choi
  - during the 9 years when the Company has been under the control of Mr. Cheng and Mr. Lee, no dividends has been declared or paid to the Shareholders
  - the Company has substantial retained profits
Choi Chi Wai (cont’d)

Conclusion:
• Mr. Cheng and Mr. Lee have conducted the affairs of the Company in an unfairly prejudicial manner towards Mr. Choi.

Order Mr. Choi to buy out Mr. Cheng and Mr. Lee
• Mr. Choi has single handedly obtained the agency business and established the modus operandi in less than 3 months, and managed to generate profits in excess of $11 million in the first 5.5 months → he is more suitable in managing the business of the Company.
• the conduct of Mr. Cheng and Mr. Lee falls far short of the standard one would expect from directors and fiduciaries, they should not be entrusted with the responsibility of managing the Company.

Directions on valuation:
• the company be valued as a whole and on a going concern basis
• the date of valuation as the actual date of sale
• no discount for minority shareholding
• taking into account the unfair prejudicial conduct, adjustment be made to the valuation of the company
Sushi Battle

Cheng Wai Tao and others v Poon Ka Man Jason (Suing on behalf of himself and all other shareholders in Smart Wave Limited except the 1st Appellant) and Another FACV 17/2015

Facts:-
• Jason, Daisy, Ricky and Shigemitsu Katsuaki were shareholders in a chain of Japanese noodle restaurants in Hong Kong under the name “Ajisen Ramen” (味千拉麺).
• In 2004, the Ajisen shareholders agreed to develop a chain of sushi restaurants, and Smart Wave Limited was set up to operate the first sushi restaurant under the name of “Itamae” (板長壽司).
• It was agreed that separate corporate vehicles would be formed to hold the interest of each said chain sushi restaurant business to be established and then they would be allotted shares of and in the said corporate vehicles.
Sushi Battle (cont’d)

Facts:

- Apart from Ajisen shareholders, Smart Wave also had five minority shareholders, who were suppliers and key staff.
- Ricky was the sole director.
- Disputes arose over the allotment of shares in the subsequent Itamae restaurants.
- At the end of 2005, the Ajisen shareholders entered into the Hero Elegant Agreement, under which, it was agreed that Jason and Daisy would be allotted shares in the Itamae business through their corporate vehicle, Fine Elite.
- Ricky subsequently went on, on his own, to set up other sushi restaurants, but refused to allot shares to Fine Elite.
Sushi Battle (cont’d)

Facts:-

• By HCA 1269/2008, Fine Elite sought specific performance of the Hero Elegant Agreement against Ricky. Mimmie Chan J found that the Fine Elite had repudiated the Hero Elegant Agreement and the repudiation had been accepted by Ricky such that he was discharged from further performance.

• Jason then brought a derivative action on behalf of Smart Wave against Ricky, for breach of fiduciary duties owed by Ricky to Smart Wave as its sole director.

At issue: whether, in the events that occurred, the fiduciary duties Ricky owed to Smart Wave were limited or cut down so as to enable Ricky to open further restaurants without breaching those fiduciary duties.
Sushi Battle (cont’d)

Majority of the CFA:-

• Ricky, as the sole director of Smart Wave, should not put himself in a position where his own interest and duties to the company conflict.

• In addition to the further restaurants being in competition with Smart Wave, there was the possibility that a business opportunity was diverted from Smart Wave.

• The scope of fiduciary duties could be modified by the unanimous and fully informed consent of the beneficiaries, i.e. all the shareholders of Smart Wave.
  
  ➢ But the agreement that each said chain sushi restaurant business was to be held by separate corporate vehicles was expressly interconnected with an expectation that they would be substantial shareholders in each such vehicle.
  
  ➢ Moreover, there was insufficient evidence that the minority shareholders also consented to the arrangement. Absent authorization by all the shareholders of Smart Wave, Ricky was clearly in breach of his fiduciary duties to Smart Wave.
Sushi Battle (cont’d)

Minority’s view:-

• There was an agreement that Smart Wave was only entitled to run one Itamae sushi restaurant in a chain of such restaurants.
  ➢ Thus, Ricky’s fiduciary duties towards Smart Wave must conform to and be consistent with that reality.
• Any shareholder of Smart Wave who felt aggrieved by reason of not being allotted shares in a company operating a restaurant further along the chain should seek redress based on breach of contract, not in a derivative action based on allegation of a breach of a fiduciary duty owed to Smart Wave.
• Note: the majority and minority in CFA drew different inference on the position of the minority in Smart Wave.
China Resources Power Holdings Company Limited (stock code 836) (HCMP 1655/2013)

- 6 Minority shareholders applied for leave (under section 168BC of the Old Cap 32, now section 732 of the CO) to enable them to commence action in the name of the company against its 20 former and current directors for negligence.

- All directors at the material time, including all INEDs (famous people like Elsie Leung, Raymond Chien) and the chairman Song Lin.

- The main allegation is that the directors caused the company to commit to over RMB 6 billion to purchase several coal mines in Shanxi without doing sufficient due diligence and when it was later found that the coal mines were worthless, didn’t enforce the company’s rights against the seller.
China Resources Power Holdings (cont’d)

• In view of the fact that the Applicants have named, among others, all the current directors of the Company as potential defendants, the Company has appointed a special advisor to the Company, who is independent of the Company, its controlling shareholders or their other subsidiaries, the directors and the staff of the Company, to deal with the further conduct of the Proceedings on behalf of the Company, with the intention and objective of ensuring that the proceedings will be conducted in the best interests of the Company with its special advisor acting independently – see Company’s announcement dated 5 August 2013
ACTIONS THAT CAN BE TAKEN BY REGULATORS
3. Actions that can be taken by regulators

“Heavy is the head that wears the crown” – William Shakespeare, Henry IV

The crucial role of company directors and senior executives

Company directors and senior executives owe very important and serious duties to the company and its shareholders. Therefore, they have a key interest not only in ensuring that the company is profitable and well-run, but also in caring for minority as well as majority shareholders.

The job is complex and getting more so. Directors and senior executives must be inquisitive, professional and diligent to do their jobs properly and with integrity. Otherwise, they run a real risk of shareholder suits, regulatory investigations or even enforcement action.

-- SFC Enforcement Reporter May 2017
SFC’s wide enforcement powers

SFC has wide enforcement powers under the SFO to ensure that directors and senior executives are held accountable for their actions:

- **Section 213**: SFC may seek injunctive and other orders for restitution or damages against anyone, including a director or senior officer, who has contravened, or aided, abetted, induced or been involved in a contravention of, any provision of the SFO.

- **Section 214**: SFC may take action and obtain court orders for breaches by current and former directors and executives which resulted in losses to listed companies. For example, SFC may seek disqualification orders for up to 15 years as well as orders that the relevant directors pay compensation or that the listed company bring legal proceedings against anyone responsible for carrying out the affairs of the company in an unfair, fraudulent or other matter specified in section 214.
SFC’s wide enforcement powers (cont’d)

- **Section 279:** Every officer of a corporation shall take all reasonable measures from time to time to ensure that proper safeguards exist to prevent the corporation from acting in a way which would result in the corporation perpetrating any conduct which constitutes market misconduct.

- **Sections 258 and 307N:** SFC may seek civil sanctions directly against any officer who failed to take reasonable measures to establish proper safeguards to prevent market misconduct, even if the officer did not personally engage in the misconduct.

- **Section 390:** Where a company has been found guilty of an offence under the SFO, the SFC may seek to extend criminal liability to any of its officers where the offence was committed with their consent, involvement or otherwise attributable to their recklessness.
Hanergy Thin Film Power Group Limited

• On 23 Jan 2017, SFC commenced legal proceedings under section 214 of SFO seeking disqualification orders against the former chairman, Mr Li Hejun (“Li”), and four INEDs of Hanergy Thin Film Power Group Limited (“Hanergy”)

• The SFC alleged that the five directors:
  - failed to question the viability of Hanergy’s business model which relied on the sales of solar panel production systems to its parent company, Hanergy Holding Group Limited (“Hanergy Holding”) and its affiliates (“connected parties”), as its main source of revenue;
  - failed to properly assess the financial positions of the connected parties and hence the recoverability of the receivables due from them as a result of these connected transactions.
  - failed to take proper steps to recover these receivables by putting the interests of the connected parties before that of Hanergy, and so did not act in Hanergy’s best interest.
Hanergy (Con’t)

• On 4 Sep 2017, SFC obtained disqualification orders against Li and the 4 INEDs:

  • Order against Li:
    ➢ disqualified from being a director or being involved in the management of any listed or unlisted corporation in Hong Kong for eight years.
    ➢ ordered to procure Hanergy Holding and/or its affiliates to pay all outstanding receivables due to Hanergy under various sales contracts
  
  • Reasoning: Li’s breaches were serious having regard to:
    ➢ his position as the chairman and executive director of Hanergy and the ultimate controller of both Hanergy and Hanergy Holding
    ➢ substantial amounts involved; and
    ➢ long period of time
Hanergy (Con’t)

• Order against 4 INEDs:
  ➢ 2 be disqualified for four years and 2 for three years

• Reasoning: the 4 INEDs were incompetent and indifferent to their responsibilities as directors:
  ➢ failed to make appropriate disclosure about the viability of Hanergy’s business model;
  ➢ failed to properly assess the financial positions of the connected parties and hence the recoverability of the receivables due from them as a result of these connected transactions; and
  ➢ failed to take proper steps to recover these receivables, and so did not act in Hanergy’s best interest
Greencool Technology Holdings Limited

• The SFC commenced proceedings in the MMT against the former chairman and CEO of Greencool Technology Holdings Limited, Mr. Gu Chujun ("Gu") and other four former senior executives, alleging that (section 277 SFO):

  • they grossly overstating Greencool’s sales, profits, trade receivables and bank deposits;
  • and grossly overstating the company’s net asset value for the financial years ended 31 December 2000 to 2004.

• One of the 4 former senior executives is the former financial controller, Mr. Henry Mok Wing Kai. Mr. Mok was also a qualified accountant.
Greencool (cont’d)

MMT’s findings:

1. Mr. Mok was negligent in performing his professional duties as a qualified accountant by failing to supervise the implementation of a sound internal control and financial reporting system.

2. His failure allowed the others, including Gu, to provide false and misleading annual results of Greencool from 2001 to 2005 to defraud the investing public.

3. The role of a qualified accountant is not limited to an adviser. He is to advise and assist the board of directors, that is, to take such steps as may be necessary to implement internal controls and other procedures that are necessary to provide the board with a reasonable basis for making sound commercial judgments.

4. And such duties extend to taking such steps as may be necessary to implement internal controls and other procedures in all the companies making up ‘the Group’.
Greencool (cont’d)

Order:-

1. Gu was ordered to disgorge approximately $481 million of profits

2. Cold shoulder order against Gu effective for five years

3. Disqualification order against Gu and four other former senior executives (3 years for Mr. Mok)
Liabilities of directors and officers for failure to disclose (cont’d)

• **Section 307G** of the SFO imposes duties on officers of listed corporations in relation to the disclosure of inside information.

• If a listed corporation has breached the disclosure requirement, an officer will also be in breach: -
  ➢ if the corporation’s breach is a result of his intentional, reckless or negligent conduct; or
  ➢ he has not taken all **reasonable measures** to ensure that proper safeguards exist to prevent the breach.
Liabilities of directors and officers for failure to disclose (cont’d)

Definition of “Officer”

- Part 1 Schedule 1 of the SFO

- An “officer” in relation to a corporation means “a director, manager or secretary of, or any other person involved in the management of, the corporation”
Liabilities of directors and officers for failure to disclose (cont’d)

Reasonable measures:

• Creation and maintenance of appropriate internal control and reporting systems

• Ensure any material information which comes to the knowledge of one or more of its officers be promptly identified, assessed and escalated for the attention of the Board of directors to decide about the need for disclosure

• Ensure a timely and structured flow of relevant financial and operational data
Civil Sanctions

**S.307N SFO** – The Market Misconduct Tribunal may, at the conclusion of any disclosure proceedings:

- impose a regulatory fine up to $8 million on the listed corporation and/or the director (s.307N(1)(d))

- disqualify the person in breach of the disclosure requirement from being a director or otherwise involved in the management of a listed corporation for up to 5 years (s.307N(1)(a)(i), (ii))

- make a “cold shoulder” order against the director or officer (i.e. the person is deprived of access to market facilities) for up to 5 years (s.307N(1)(b))
• a “cease and desist” order on the listed corporation, director or officer (i.e. an order not to breach the statutory disclosure requirements again) (s.307N(1)(c))

• an order that any body of which the director or officer is a member be recommended to take disciplinary action against him (s.307N(1)(g))

• payment of costs of the civil inquiry and/or the SFC’s costs (s.307N(1)(e),(f))

• an order that a corporation to appoint an independent professional advisor to review its compliance procedure (s.307N(1)(h))

• an order that the officer undergo training (s.307N(1)(i))
Regulatory fine up to $8m

- **NOT** an aggregate amount
- The listed corporation and each of its directors could be fined up to $8 million separately

- **S.307N(3) SFO**
  - Principle of proportionality and reasonableness
    - The fine must be proportionate and reasonable in relation to the breach of the disclosure requirement
  - Relevant factors
    - Seriousness of the conduct
    - Whether the conduct was intentional, reckless or negligent
    - Whether the conduct may have damaged the integrity of the securities and futures market
Regulatory fine up to $8m

- **NOT** an aggregate amount
- The listed corporation and each of its directors could be fined up to $8 million separately

S.307N(3) SFO

- Principle of proportionality and reasonableness
  - The fine must be proportionate and reasonable in relation to the breach of the disclosure requirement
- Relevant factors:
  - Seriousness of the conduct
  - Whether the conduct was intentional, reckless or negligent
  - Whether the conduct may have damaged the integrity of the securities and futures market
Other remedies

- S.307Z and s.307ZA SFO

- Persons suffering pecuniary loss as a result of others breaching the disclosure requirements could rely on the MMT findings to take civil actions to seek compensation from those having breached the disclosure requirements

- But to date, no suit has been brought under s.307Z of SFO
AcrossAsia Limited

- AcrossAsia Limited (AAL) is an investment holding company listed in Hong Kong. Mr Cheok is its Chairman and Mr Ang is its CEO.

- A winding-up petition was presented against AAL by PT First Media Tbk (First Media) in Indonesia on 20 December 2012. The petition sought a temporary freezing order on AAL’s debts in order for a composition plan to be drawn up, and for an Indonesian judge and administrators to be appointed to manage AAL’s assets.

- Mr Cheok and Mr Ang and other officers of AAL received the English translation of the court documents on 4 Jan 2013. Petition was granted on 15 Jan 2013. However, no announcement was made until 17 Jan 2013.

- The SFC alleges that the information in relation to the Petition was inside information.
AcrossAsia Limited (cont’d)

• On 22 July 2015, the SFC commenced proceedings in the MMT against AAL, its chairman and its CEO for non-disclosure of inside information under the SFO.

• The MMT found that:-
  ➢ AAL failed to disclose inside information as soon as reasonably practicable as required under section 307B(1) of the SFO
  ➢ Mr. Cheok and Mr. Ang breached the disclosure requirement under section 307G of the SFO

• The MMT fined AAL $600,000, Mr Cheok $800,000, and Mr Ang $600,000
Rontex International Holdings

- The SFC commenced action against the three executive directors of the company, alleging that they:
  - failed to ensure Rontex fully complied with disclosure requirements under the Listing Rules; and
  - failed to exercise reasonable skill, care and diligence in entering into a number of transactions, resulting in Rontex suffering losses and damages of about $19 million.

- The SFC sought disqualification orders and orders for Rontex to commence actions for recovery of compensation against the three directors.
Rontex International Holdings (cont’d)

Findings:-

- The directors were in breach of duty and had failed to exercise reasonable care in, *inter alia*, causing the company to make investments in particular businesses without carrying out adequate due diligence or proper appraisal of the worth of the investments.

- The directors breached the disclosure obligation under the Listing Rules, resulting in its members not having been given all the information with respect to its business or affairs that they might reasonably expect.
  
  Note: this is based on section 214(1)(c) of the SFO.
Rontex International Holdings (cont’d)

Order:-

1. Disqualification order against R1 (5 years), R2 (5 years) and R3 (4 years). On appeal, R2’s length of disqualification was reduced to 4 years.

2. Direct Rontex to bring legal proceedings against the three former directors for compensation
   - this is the first time the SFC has obtained an order in the High Court directing a listed company to commence civil proceedings to seek recovery of compensation for the loss and damage suffered by the company as a result of director’s misconduct (section 214(2)(b) of SFO)
PME Group Limited

• In August 2013, the SFC prosecuted PME Group Limited, a Hong Kong-listed company, in relation to the allegations that PME had made false or misleading stock exchange announcements, in contravention of section 384 of the SFO.

• It was alleged that:-
  - in 2008, PME made three announcements respectively in response to the inquiries made by the SEHK in the light of the substantial movement of the share price of PME.
  - In each announcement, PME stated that it knew of no negotiations or agreements which were disclosable to the market nor were its directors aware of any price sensitive matter.
  - However, it was later uncovered that PME was at that time taking steps to acquire 50% of another Hong Kong-listed company, with a market value of about $145 million.
  - The SFC argued that PME ought to have disclosed the transaction in the announcements, and its failure to do so constituted a breach of section 384 herein.
PME Group Limited (cont’d)

• SFC also prosecuted PME’s director, Ms. Ivy Chan Shui Sheung, for her alleged involvement in the offences by PME, pursuant to section 390 of the SFO

• Section 390(1) of the SFO provides that where a corporation is guilty of an SFO offence, any officer of the corporation, or any person who purports to act in any such capacity, is accordingly liable if that officer aided, abetted, counselled, procured or induced the commission of the offence by the corporation, or the offence was committed by the corporation with the consent or connivance of the officer, or the commission of the offence by the corporation was attributable to any recklessness of the officer
PME Group Limited (cont’d)

• PME pleaded guilty to three counts of making false or misleading announcements → fined $60,000 and ordered to pay investigation costs to the SFC

• Ms. Chan was acquitted:-
  ➢ she had relied on the company secretary to decide whether the acquisition was disclosable or not and therefore did not possess the required mens rea.
  ➢ Acquittal upheld on appeal
CITIC Pacific Case

Facts:-

• CITIC Pacific was the holding company of a number of subsidiaries including Sino Iron Pty Limited and CITIC Pacific Mining Management Pty Limited. In July 2008, CITIC Pacific decided to hedge its exposure to AUD500 million which CITIC Pacific required for its iron-ore mining project in Australia owned by these two companies. In July and August 2008, CITIC Pacific entered into various Target Redemption Forward contracts (“TRF Contracts”) to hedge the fluctuations of AUD, Euro, and Renminbi against the US dollar.

• Between July and September 2008, the AUD/USD spot rate dropped significantly. By October 2008, the mark-to-market loss of the outstanding TRF Contracts was HK$14.7 billion, which was significantly in excess of the AUD 500 million exposure which the TRF Contracts were intended to hedge for the Sino Iron Project.
CITIC Pacific Case (cont’d)

Facts:

• On 20 October 2008, CITIC issued a Profit Warning Announcement (the “Announcement”) in respect of losses primarily linked to the TRF Contracts. The Announcement also stated that CITIC “became aware of the exposure arising from [the TRF Contracts] on 7 September 2008”.

• It was discovered by the SFC that on 12 September 2008, CITIC has issued a circular stating that the “Directors are not aware of any material adverse change in the financial or trading position of the Group since 31 December 2007.”

• The MMT was asked by the SFC to determine whether the fact that the circular contained a no material adverse change statement as of 7 September 2008 had a false or misleading impact on the market.
CITIC Pacific Case (cont’d)

MMT’s findings: -

• There was no evidence to draw the inference that the market was relying on assurances that setbacks would not materially affect CITIC’s financial position

• Evidence suggested that in the weeks before the publication of the Circular, CITIC shares had largely kept pace with the HSI and continued to do so for at least three weeks after publication → the “no-MAC” publication had no influence at all on CITIC’s share price
CITIC Pacific Case (cont’d)

MMT’s findings: -

- The concept of MAC is to be determined objectively by looking to the available financial and other relevant information

- For a MAC to be demonstrated, the change must be “one of deep significance to that company’s existing financial position, a change that has undermined its financial integrity … it must be demonstrated to be a change that is not merely temporary but is one that, judged in all the circumstances, is a change that will endure … for months or longer”

- Whilst the data available by 7 September demonstrated a real danger of a MAC in CITIC’s financial position at some point in the future, that data was not capable of demonstrating that there was already in existence an actual MAC. Even if a MAC had already occurred, it was not demonstrated that it would clearly endure

Conclusion: No market misconduct in CITIC’s publication of the Circular
What directors and executives can do to guard against corporate misconduct?

- Effective internal controls
- Whistleblowing policies
- Establish a company-wide culture of checks and balances
- Directors to take the lead to discuss governance-related matters on a regular basis
- Getting regular updates on management accounts and corporate performance, etc.
THE RISKS FACED BY DIRECTORS OF INSOLVENT COMPANIES
4. The risks faced by directors of insolvent companies

• Whose interests shall directors safeguard?
  ➢ shareholders’ vs creditors’ interests

• *Kinsela v Russell Kinsela* (1986) 4 ACLC 215
  ➢ The company in financial difficulties entered into a leasing agreement with its directors at a substantially undervalued rent. The company went into liquidation subsequently.
  ➢ A question arose as to whether (1) such transaction involved a breach of directors’ duty and (2) the transaction could be avoided even though it had been approved of by all the shareholders.

• Held:
  • The interests of creditors intervene on insolvency, so that directors have to have regard to them in exercising their powers in relation to a company’s assets.
**Kinsela v Russell Kinsela (cont’d)**

- Street CJ at 730A-C:

  “In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But **where a company is insolvent, the interests of the creditors intrude**. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.”
The company was plainly insolvent at the date of the lease and its collapse on that ground was imminent.

The prejudice to the creditors was the direct and calculated result of the lease; its purpose was to place the company's assets beyond the reach of the creditors.

Based on the above, the court held that the company’s challenge was made good.
Trading while insolvent

• Although there is not yet any legislation on insolvent trading in Hong Kong (unlike in the UK), directors should be aware of the financial status of the company, especially if there are signs that the company has become insolvent.

• Where the directors failed to have regard to the company’s financial status and caused the company to enter into certain transactions in breach of their fiduciary duties with losses incurred,
  • The directors can be liable for such losses! \textit{Moulin Global Eyecare Holdings Limited (In Liquidation) & Ors v Olivia Lee Sin Mei} (HCA 167/2008).
Moulin Global Eyecare Holdings Ltd (in liquidation) & Ors v Olivia Lee Sin Mei

Facts:-

- The liquidator of Moulin Global Eyecare Holdings Limited brought action against the Defendant, Ms. Lee, a former director and legal adviser to the company, for breach of contractual, common law and fiduciary duties.

- Four years after the writ was issued, the liquidators sought to add three new causes of action:
  
  ➢ The **Convertible Notes Loss** claim: - where amounts totalling US$15 million and more than HK$98 million were paid out for early redemption of convertible notes

  ➢ The **Share Repurchases Loss** claim:- where more than HK$37 million was paid for share repurchases out of capital when Moulin was not in a position to make such repurchase; and

  ➢ The **IND Loss** claim:- for increase in net deficiency of Moulin in the period between the time when the company should have been placed into liquidation and the time when it actually went into liquidation.
Moulin (cont’d)

The IND Loss claim

- “Further and in the alternative … the [Company] suffered loss of at least HK$1.23 billion constituting the increase in the net deficiency of the [Company] from at least 31 March 2001 until the date of appointment of the Provisional Liquidators on 23 June 2005, an increase from a net deficiency of HK$745 million had Provisional Liquidators been appointed as at 31 March 2001 to the actual net deficiency in winding up of the [Company] of HK$1.98 billion.”
- i.e. HK$1.98 billion – 745 million = HK$1.23 billion

The IND claim is premised upon the following:-

1. By 31 March 2001 the latest, Ms. Lee knew or ought to have known, that the Company was insolvent and there is no hope to trade out of insolvency;
2. She should have procured the appointment of PL or otherwise blown the whistle;
3. Instead she let the Company trade on and as a result there was an IND of HK$1.23 billion by the time the Company was wound-up.

Ms. Lee sought to strike out the three new causes of action.
Moulin (cont’d)

Barma J (at first instance):-

• The **Share Repurchases Loss** claim: struck out
  ➢ Time-barred

• The **Convertible Notes Loss** claim: struck out
  ➢ the payment discharged genuine liabilities and as such the plaintiff had not suffered any loss
  ➢ Time-barred

• The **IND Loss** claim: allowed
**Moulin (cont’d)**

**Court of Appeal:-**

- The **Share Repurchases Loss** claim: upheld

- The **Convertible Notes Loss** claim: upheld
  - Directors owed a duty to consider the creditors’ interests when the company is insolvent
  - The duty, however, is not owed to the creditors but to the company
  - The early redemption was the payment of a genuine liability of the company, as such Moulin suffered no loss. Loss was suffered by the general creditors → appropriate cause is unfair preference

- The **IND Loss** claim: allowed appeal → strike out
  - The amendment did not arise out of substantially the same facts → it considerably broadened the scope of factual inquiry
  - The amendment was made outside the limitation period
Moulin (cont’d)

Court of Final Appeal:
If the nature and scope of the claims were within the scope of the writ, they would not be new causes of action. All three claims were within the purview of the indorsement on the writ → not time barred

- The Share Repurchases Loss claim: allowed to be added

- TheConvertible Notes Loss claim: Plaintiff to seek leave to re-plead
  ➢ Not time-barred
  ➢ Plaintiff’s proposition arguable
  ➢ But theConvertible Notes Loss claim pleaded did not plead a triable cause

- The IND Loss claim: allowed to be added
  ➢ Not time-barred
Moulin (cont’d)

The Convertible Notes Loss
the CFA held that, even though in one sense the company suffered no loss, the claim was maintainable if framed as a claim for breach of the prescriptive fiduciary duty.

The CFA accepted the following propositions put forward by counsel for the liquidators:-

• 1. A director owes a duty to act *bona fide* in the best interests of the company.
• 2. In an insolvency context the duty requires the director to take into account the interests of creditors.
• 3. The duty may extend to not prejudicing the interests of creditors and preserving the assets of the company so that those assets may be dealt with in accordance with ordinary principles of insolvency law, including the fundamental principle of *pari passu* distribution of the company’s assets amongst all creditors.
Moulin (cont’d)

• 4. A director who knowingly causes a company to pay away company assets to a creditor (and who thereby dissipates those assets so that they are not available for pari passu distribution to all creditors) when he does not subjectively believe that the payment is in the best interests of the company may act in breach of duty.

• 5. The company may pursue equitable remedies (such as equitable compensation) against the director to restore the company to the position that it was in prior to the breach of duty.

• 6. The assets restored to the company are then available for pari passu distribution amongst all creditors.

• 7. Equitable remedies are discretionary. The court has power to mould relief depending on the nature and facts and circumstances of the individual case. As a result, orders can be made to ensure that the company and the general body of creditors are not overcompensated.
Moulin (cont’d)

• However, the CFA still regarded the pleadings in respect of the Convertible Notes Claim as “embarrassing” and further amendments would be required. It was allowed to stay only because such claim was held to be, in principle, capable of falling within the purview of the general indorsement of claim filed by the liquidators

• **Implication:** The final outcome is still pending, but the Moulin case demonstrates the possibility of a misfeasance claim based on insolvent trading.
Concluding Words

- A director owes fiduciary duties to the company and must exercise the statutory duty of care
- Directors of listed companies are subject to additional obligations under the listing rules and other statutory provisions
- Minority shareholders may petition unfair prejudice against the directors/majority shareholders. The court may order winding-up of the company, make a buy-out order and/or other relief the court thinks fit. Minority shareholders may also bring derivative action on behalf of the company against the delinquent directors
- The regulators have wide enforcement powers and recent SFC enforcement reporter seems to suggest that a higher burden is placed on the directors
- When the company is insolvent or near insolvency, the director’s duties are owed to the company’s creditors, thus the directors must have due regard to the interests of the creditors
Thank you! 😊
Important: The law and procedure on this subject are very specialised and complicated. This seminar is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.
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