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Directors' and Officers' Liability for Negligence

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Basic principle:

- Directors and officers owe a duty of care to the company to act with reasonable care, skill and diligence.

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Chingtung Futures Ltd (in Liq) v Arthur Lai [1992] 2 HKC 637

- Chingtung was a causality of the 1987 Black Monday.
- A customer defaulted in HSI Futures contracts trading causing Chingtung a loss of HK$87m – and its collapse.
- The liquidator sued Arthur Lai, its director, for negligence.
- Arthur was responsible for procuring the customer, opening and servicing the account.
- The alleged negligent acts included:-
  - Failure to know its customer: someone from Thailand (Mr. Sukham) called Arthur, claiming to be referred by a solicitor, requesting to open an account. The money was said to be from a "Thai General" who did not want his ID to be revealed. The account was opened through a Liberian company. Neither the ID of the Thai General or the solicitor who referred him to Arthur was ever found out. Mr. Sukham disappeared shortly after the Black Monday.
  - Failure to obtain a proper guarantee from someone with credit standing.
  - Failure to require sufficient margin to be deposited (the actual margin deposited was even lower than that recommended by the exchange).

Defences put up by Arthur:-

- Not negligent. Relaxing guarantee and margin requirement was a result of market competition.
- **Held:** it may be a matter of extent but the risk taken by Chingtung in this case was too big. Even Arthur's expert witness said so.

- A negligent person is only liable for 'reasonably foreseeable loss' - Black Monday was not something foreseeable.
- **Held:** The 1973 market collapse was even bigger in percentage terms. Futures market is inherently volatile. What needs to be "reasonably foreseeable" is the kind of loss, not the extent. And he would be liable for all the loss, not just the 'reasonably foreseeable' part.

- Arthur could have procured Chingtung to 'ratify' his mistakes, if any, as he was in control of its board and shareholders meeting.

Defences put up by Arthur:-

- **Held:** On the fact, he never did so. As a matter of law, if it's the kind of loss that caused the company to collapse, it's not something capable of ratification.

- Relief under s.358 of CO:-
  - *If in any proceeding for negligence, default, breach of duty, or breach of trust against a person to whom this section applies it appears to the court hearing the case that that person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit.*

Defences put up by Arthur:-

- **Held:** No dishonesty on Arthur's part. However, he had not acted reasonably. Arthur, *"a man of very considerable ability who, lured by large profits, ran dreadful risks and unfortunately must now bear the consequences*

The point on 'ratification' highlights the principle that the "Company", to whom the director's duty is owed, has different meanings depending on whether the company is solvent or insolvent.

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Whose interests should the 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 for its most important asset 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."

West Mercia Safetywear Ltd v Dodd [1988] BCLC 250

- A director caused the company to transfer a sum of money to its holding company, of which he was also a director, and whose overdraft he had guaranteed, in partial repayment of amounts which it owed to the holding company at a time when both companies were on the verge of liquidation.
- The company subsequently went into liquidation and its liquidator claimed that the director was guilty of misfeasance and breach of duty.
- The director was ordered to repay for the amount paid to the holding company.

One doesn't need to be as negligent as Arthur to be liable to one's company.

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D'jan of London Ltd [1994] 1 BCLC 561

- A fire destroyed the Company's factory.
- The insurance company repudiated the policy and declined to compensate.
- Director of the company found liable for negligence in filling in an insurance proposal form. The proposal form asked "have you ever been a director of a wound-up company?" He answered "no", which was a wrong answer.
- Defence: The director entrusted a reliable insurance broker to fill in the form.
- **Held:** The task (filling in proposal form) was not something so professional and difficult as to justify a total delegation without minimum checking.
- Defence: s.358 Relief
- **Held:** The director has not been dishonest. He could have ratified his fault easily whilst the company was still solvent (but failed to do so). The relief was allowed to the extent that the director was deprived of the right to file his own proof of debt.

The principle and scope of the duty of care is now codified for HK.

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s. 465 of the new CO

" (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."

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Judicial elaboration

Re Barings plc and others (No.5) [2001] BCC 273, para 36:

(i) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.

(ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.

(iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company."

Negligence claims against directors and officers…

- Note that s.465 CO is a hybrid test comprising both “objective” and “subjective” standards. This is a strong disincentive for occupying position outside one’s competence.
- The claim is not confined to the director whose acts cause direct loss to the company. Directors failing to **prevent** such acts from happening could be held liable.
- Similar duties apply to employees. ***Lister v. Romford Ice and Cold Storage Co Ltd*** [1957] AC 555 at 572

- These are aptly illustrated by the case of ***Weavering Capital (UK) Ltd. v. Peterson*** [2012] EWHC 1480 (Ch).

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Weavering Capital (UK) Ltd. v Peterson (cont'd)

Fraud,
breach of fiduciary duty

Negligence

CE/MD

Investors

$

Advice
and
Manage

Liquidators

D1

Couple

D2

Director

Control
(father and
brother
nominees)

WCF

OTC
transactions

Macro
(in liq)

Public fund

Manager
and
Adviser of
Macro

WCUK
(in liq)

WEAVERING
CAPITAL

D9

Director

Swaps

FRAs

D10

**Senior
employee**

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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 pre-dominantly exchange-traded (as opposed to OTC).

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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.


THE TI

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Lehman collapse sends shockwave round world

hares and oil prices plunge, thousands lose jobs

Dow Jones industrial average was down 300 points, or 2.6 per

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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*".

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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.

Weavering Capital (UK) Ltd (In Liquidation) v Dabhia [2013] EWCA Civ 71

- The director (D9) and the senior employee (D10) appealed against the English High Court's decision on the grounds of causation, incorrect findings and procedural irregularity.
- Main ground of appeal:-
- "Mr. Peterson was found to be a plausible liar with a charismatic personality. The Judge herself described her impression of Mr Peterson in giving evidence as a man who "had an answer for everything" but that his answers "depended upon an exceptionally plausible manner rooted in his own confidence in himself".
- Even if D9 and D10 had raised questions, Mr. Peterson would overwhelm them and have his instructions carried out.
- **Held (by CA):** for such a defence to hold, Ds must plead with particulars what questions they would have raised and what answers Mr. Peterson would have given.
- Further, they had a duty to deal honestly with outside parties such as auditors, custodian and regulatory authorities and they failed to do so.

Some food for thought…

- The cases clearly show that duties of directors and employees are owed to the company, not its controlling director or even sole shareholder, especially when the company is insolvent – this is a counter-intuitive principle overlooked by most employees every day – following the instructions of the controlling director/sole shareholder is NOT a defence to a claim for breach of duties to the company.

See also
R v Michael Chua, CACC 64/1991, para 7:-

- *"If an employee does something for an employer because the employee believes that the instructions came from the employer and therefore had to be followed, or because the employee wants to help the boss, or because the employee thinks that he or she might lose their jobs, and that at the time the employee did the act requested by the employer he knew that ordinary, reasonable people would consider what he was doing to be dishonest, then the employee is not excused and would be considered to have acted dishonestly.*

- ***The employee is only in law excused if he or she acted under duress, that is, under threat of death or serious bodily injury….****"*

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What would a negligent director be liable for:-

- "… having established breach of duty it was necessary for the court to construct "a necessarily hypothetical edifice so as to ascertain what would probably have happened if the relevant duties had been performed".

  Weavering (CA), para 50

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Moulin Global Eyecare Holdings Ltd (in liq) v Olivia Lee (HCA 167/2008)

Decision of Barma J on 27 June 2012 explains the extent of the negligent director's liability in the case of a collapsed company:-

- The primary case of the liquidators is that Olivia, as a non-executive director and member of audit committee, failed to detect accounting irregularities and signs of insolvency. She should have taken step to put the company into liquidation much earlier than it otherwise was.
- As a consequence, the company continued trading whilst it should not have been and incurred further losses.
- The relevant time for calculating the Company's loss is the period between the time when the Company should have been placed into liquidation, and the time when it actually went into liquidation (the "Relevant Period", a period of more than four years, from 31 March 2001 to 23 June 2005).
- Liquidators claimed against Olivia for the Increase in Deficiency during the Relevant Period.

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Olivia applied to strike out the claim on the basis, arguing that she should only be liable for Net Increase in Deficiency during the Relevant Period, i.e., any inflow of capital to the company during that period should be taken into account and set off against the company's losses.

Held: -

- The inflows of money during the Relevant Period would only be relevant in so far as they could be said to be logically or causally connected to the losses that were claimed.
- "Benefit or profit received where the negligence or breach of duty complained of gave rise to the opportunity, or set the scene, for the receipt of the profit, but did not cause it directly" need not be taken into account.
- The Increase in Deficiency claim is an arguable point and should not be struck out.

There is an appeal of Barma J's judgment to the CA (on the ground of limitation, see below), but not on the method of loss quantification.

Possible legal defences available to the negligent director

- Olivia attempted to strike out the whole claim against her on three legal (as opposed to factual) grounds:-
  1. She has been given an indemnity by the company under its articles and a Deed of Release and Indemnity so any claim against her would be circular.
  2. The liquidator failed to renew her D&O insurance making her exposed.
  3. Limitation

Indemnity from the Company

- The Company executed a Deed of Release and Indemnity which indemnifies the director of all amounts that the director "*may be required to pay…arising out of or in connection with any complaint, investigation, claim, proceeding or action that may be taken by anyone, including but not limited to…the Regulatory Authorities…and any other private or public third party*"

- Olivia tried to strike out the claim of the liquidator on the basis that the indemnity also covers claims made by the company against her. Hence, the liquidator's claim would be circular.

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Indemnity from the Company

- However, the Court of Appeal held that another clause in the Deed which provides that

  – "All payments under this Release and Indemnity shall be made in full without set-off or counterclaim or any restriction or conditions and free and clear (of) **any of the Company's present or future claims (if any) against [the director]**"

  This clause implied that the company's right to sue the director has not been entirely excluded. The indemnity was held to apply to third party claims only, not a claim by the Company.

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Indemnity from the Company

- Olivia also tried to rely on the Byelaws of the company which provides that the company shall indemnify the directors in respect of anything done or omitted to be done as directors and gives the directors immunity from suit except in relation to any wilful negligence, wilful default, fraud or dishonesty and that such terms have been incorporated into her terms of engagement as a director.

- **Held (CA)** :
  1. The Articles of the Company does not constitute a contract between the company and a director
  2. Whether the Articles has been incorporated into the terms of engagement is a matter of fact that shall be determined at trial

Indemnity from the Company

- Moulin is a Bermudan company, for HK companies, s.165(1) CO provides:-

- *Any provision in the articles of a company or in any contract with a company which exempt or indemnify any officer of the company from any liability to the company or a related company in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty of shall be void.*

- Implications?

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D&O Insurance

- Companies may purchase and maintain insurance for any officer of the company in relation to any liability to the company arising as a result of any negligence, default, breach of duty of breach of trust of which he may be guilty in relation to the company or a related company (s165(2) CO)

  Thus the purchase and maintenance of directors' liability insurance shall protect the directors
- The policy bought by Moulin should be able to cover the claim against Olivia. However, it only covered claims made during the currency of the policy.
- Olivia claimed it was the liquidators default that they did not renew the policy and it had lapsed by the time the claim was made against Olivia.
- **Held:** taking Olivia's case to the highest, the insurance provides indemnity only up to US$10m, a small fraction of the claim against Olivia.

Limitation

- *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* CACV 155/2012 and CACV 161/2012
- The original SOC claimed Olivia against unlawful payment of dividends, overpaid tax and banking charges for fake transactions.
- Liquidator sought to amend SOC to introduce new claims including
  - Share repurchases made by the Company: HK$37million between 2001 and 2003
  - A further claim of increased deficiency of the Company from 2001 to 2005 was sought to be added: HK$1.23 billion
  - More than 6 years has lapsed when the application to amend the SOC was made

Limitation (cont'd)

- Defendant Director sought to strike out ASOC, CA held:
  - The Share Repurchase claim is a new cause of action for the purpose of s. 35 of the Limitation Ordinance and O20 r5 of the RHC and did not arise out of the same or substantially the same facts as a cause of action in respect of which relief has already been claimed within the limitation period.
  - As regards the Increase in Deficiency claim, the liquidator argued that the factual basis was the same as the original claims, i.e., general breach of duty of care in not spotting signs of insolvency and allowing the Company to continue trading.
  - CA rejected this argument and held that breaches of duties causing the Increase in Deficiency must be pleaded with full particulars and cannot be lumped into a general breach of duty of care.

Limitation defence: *New China Hong Kong Group Ltd v Ernst & Young* HCCL 41/2004, 2/2005

- This is an action against former auditors and director which was struck out on the ground of limitation period.

- The companies claimed against EY and Anthony Wu for **breach of common law duties** in failing to report various problems to the Companies' management/ the Executive Committee or warn them of the same.

- EY and Anthony applied to Court to strike out the claims on the ground that the actions were time-barred.

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New China Hong Kong Group Ltd v Ernst & Young

- Limitation periods applicable to **negligence claim**:

  S. 31 of Limitation Ordinance:

  – 6 years from the date of **accrual** of cause of action; or

  – 3 years from the date of **knowledge**, if that period expires later.

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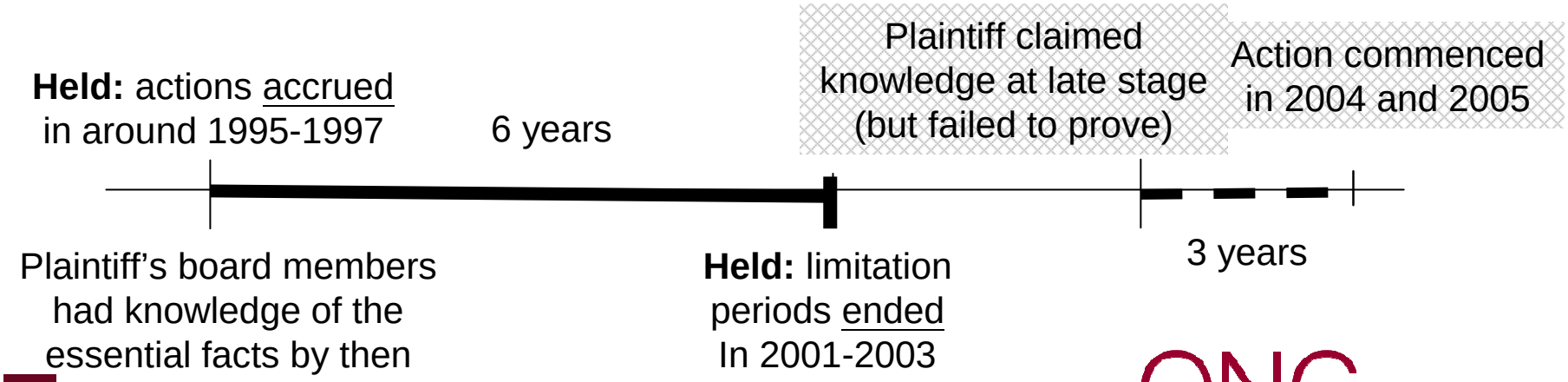
Limitation defence: *New China Hong Kong Group Ltd v Ernst & Young*

- The companies relied on section 31 LO and contended the causes of action were not **accrued** until the companies' liquidation which is within the time limit.
- The companies argued that the relevant facts were **unknown** to them so as to postpone the running of time until a moment within 3 years of the commencement of the respective actions.
- The above arguments were rejected by the CFI.



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New China Hong Kong Group Ltd v Ernst & Young

Held:

- The independent members of the boards of the Companies (e.g. finance director of the executive committee and common director of the companies) had **knowledge of the essential facts of the claims**.
- By operation of the general rules of attribution, the knowledge acquired by those specifically charged with monitoring the credit positions of the clients should be imputed to the company.

- The causes of action have **accrued** more than 6 years before the commencement of the respective actions against the Defendants.
- The claims were time-barred.

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Not only a matter of insolvency…

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Statutory derivative action against directors

- Minority shareholders took out derivative action against directors for breach of directors' duties in connection with the company's investments in certain coal mine assets in Shanxi Province.

- S. 168BC CO provides that:

  "(1) A member of a specified corporation or of a related company of a specified corporation may, with the leave of the court granted under subsection (3)—

  (a) bring proceedings before the court on behalf of the specified corporation…"

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Statutory derivative action against directors

- Further, under s. 168BG CO, the court may make an order for independent investigation as to the financial position of and other affairs of the company.

Statutory derivative action against directors (cont'd)

- S. 168BG CO provides that:

  "(1) The court may…make any order and give any direction it considers appropriate in respect of any proceedings brought…by a member of a specified corporation, or of a related company of a specified corporation, under section 168BC(1), or in respect of an application for leave made under section 168BC(3), including -

  …

  (c) an order directing the specified corporation, or an officer of the specified corporation, to do, or not to do, any act (including the provision by the specified corporation or the officer of such information or assistance as the court may think fit for the purpose of the proceedings or application); and

  (d) an order appointing an independent person to investigate and report to the court on—

  (i) the financial position of the specified corporation;

  (ii) the facts or circumstances that gave rise to the proceedings; or

  (iii) the costs incurred by the parties to the proceedings, and by the member who brought or intervened in the proceedings, or made the application."

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KEY POINTS AND CONCLUSION

- Company directorship could be a high risk profession.
- Your duty is owed to the Company and, when its insolvent, the creditors, NOT your friend who nominated or appointed you.
- Don’t go beyond your competence – delegation may not be sufficient protection.
- Protect yourself with Insurance, Indemnity and … Commensurate Pay !

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Thank you!

The End

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