

▶ Directors' Roles & Responsibilities – Dealing with Dysfunctional Boards/Crises/Emergencies



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THE LEGAL ISSUES

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BACKGROUND

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ROLE OF LAWYERS

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Directors' Fiduciary Duties

Definition of "Director":

- ▶ includes any person who occupies the position of a director by whatever name called
- ▶ includes a "shadow director" – a person in accordance with whose directions or instructions the directors or a majority of them are accustomed to act (s2 CO)

Companies Registry – A Guide on Directors' Duties:

- ▶ To act in good faith for the benefit of the company as a whole
- ▶ To use powers for a proper purpose for the benefit of the company's members as a whole
- ▶ Not to delegate powers except with proper authorisation and to exercise independent judgement in relation to any exercise of powers
- ▶ To exercise care, skill and diligence
- ▶ To avoid conflicts between personal interests and interests of the company
- ▶ Not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law
- ▶ Not to gain advantage from use of position as a director
- ▶ Not to make unauthorised use of company's property/information
- ▶ Not to accept personal benefit from third parties conferred because of position as a director
- ▶ To observe the company's memorandum and articles of association and resolutions
- ▶ To keep proper books of account

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Directors' Fiduciary Duties (Cont'd)

Listing Rules Requirements:

- ▶ The Listing Rules impose similar obligations on all HK listed companies regardless of their place of incorporation.
- ▶ The directors of a listed company are expected, collectively and individually to fulfill fiduciary duties and standards of skill, care and diligence to a standard equivalent to that required under HK law (Rule 3.08).
- ▶ Listed company directors are also collectively responsible for the company's management and operations.
- ▶ Minimum requirement: directors must take an active interest in the listed company's affairs and obtain a general understanding of its business.
- ▶ Directors of listed companies must follow up anything untoward that comes to their attention.

Five areas of potential civil and/or criminal liability

A. Fraudulent trading (s275 CO)

▶ Civil liability

If in the course of the winding up of a company, it appears that any business of the company has been carried on with **intent to defraud creditors** of the company or creditors of any other person or **for any fraudulent purpose**, any persons who were knowingly parties to the carrying on of that business shall be **personally responsible** for **all or any of the debts or other liabilities** of the company.

▶ Criminal liability

Where any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, every person who was knowingly a party to the carrying on of that business shall be guilty of an offence, **whether or not the company has been or is in course of being wound up** and liable to imprisonment and a fine.

Five areas of potential civil and/or criminal liability (Cont'd)

B. New statutory regime for disclosure of PSI effective 1 January 2013

- ▶ Definition of PSI (“inside information”) (s307A SFO)
 - Specific information about:
 - * The corporation;
 - * A shareholder or officer of the corporation; or
 - * The listed securities of the corporation or their derivatives;

AND

- * is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but would if generally known to them be likely to materially affect the price of the listed securities.

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Five areas of potential civil and/or criminal liability (Cont'd)

B. New statutory regime for disclosure of PSI

▶ Timing of disclosure (s307B(1) SFO)

- A corporation must disclose PSI to the public **as soon as reasonably practicable after** any inside information has **come to its knowledge**

▶ “come to its knowledge”

- the inside information has, or ought reasonably to have, come to the knowledge of an officer of the corporation in the course of performing functions as an officer of the corporation; **AND**
- a reasonable person, acting as an officer of the corporation, would consider that the information is inside information in relation to the corporation (section 307B(2) SFO).

Five areas of potential civil and/or criminal liability (Cont'd)

B. New statutory regime for disclosure of PSI

▶ Definition of “officer”:

- a director, manager or secretary of a corporation or any other person involved in its management (Part 1 of Schedule 1 to the SFO)
- “manager”: person who under immediate authority of the board, has management responsibility for all or a substantial part of a corporation

▶ Possible penalties:

- * A **fine** of up to HKD 8 million on the corporation, its directors and chief executive;
- * **Disqualification** of a director or officer for up to 5 years
- * A **cold shoulder** order for up to 5 years
- * A **cease and desist** order
- * A **disciplinary referral** order
- * **SFC costs order**
- * A corporation or officer in breach of the disclosure obligation may be liable to pay **compensation** to any person who has suffered financial loss as a result of the breach in separate proceedings (s307Z SFO)

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Five areas of potential civil and/or criminal liability (Cont'd)

B. New statutory regime for disclosure of PSI (Cont'd)

Potential Liability of Officers

- ▶ A corporation's officers are required to take all reasonable measures to ensure that proper safeguards exist to prevent the corporation's breach of the PSI disclosure requirement (section 307G(1) SFO).
- ▶ Although an officer's breach of this provision is not actionable of itself, an officer will be regarded as having breached the PSI disclosure obligation if the listed corporation has breached such obligation and either:
 - * the breach resulted from the officer's intentional, reckless or negligent conduct; or
 - * the officer has not taken all reasonable measures to ensure that proper safeguards exist to prevent the breach (section 307G(2) SFO).
- ▶ SFC Guidelines on Disclosure of Inside Information
 - * officers, including non-executive directors, must ensure that appropriate systems and procedures are put in place and reviewed periodically to enable the corporation to comply with the disclosure requirement
 - * officers with an executive role also have a duty to oversee the proper implementation and functioning of the procedures and to ensure the detection and remedy of material deficiencies in a timely manner.

Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

Parts XIII and XIV of the Securities and Futures Ordinance (the “SFO”) regulate six 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 and
- * stock market manipulation

Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

Parts XIII and XIV SFO contain virtually identical civil and criminal offences in relation to each type of market misconduct.

Part XIV SFO creates 3 additional criminal offences:

- * use of fraudulent or deceptive devices in transactions in securities, futures contracts or leveraged foreign exchange trading
- * disclosure of false or misleading information inducing others to enter leveraged foreign exchange contracts
- * falsely representing dealings in futures contracts on behalf of others.

Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

▶ Civil proceedings

Civil proceedings for market misconduct are brought before the Market Misconduct Tribunal (the “MMT”) and their purpose is to determine:

- whether any market misconduct has taken place;
- the identity of every person involved in the market misconduct; and
- the amount of any profit gained or loss avoided as a result of the market misconduct.

The MMT may identify a person as having engaged in market misconduct if:

- he has perpetrated any market misconduct;
 - the market misconduct was perpetrated by a corporation of which he is an officer with his consent or connivance; or
 - another person engaged in market misconduct and he assisted or connived with that person in the perpetration of the market misconduct, knowing that such conduct constitutes or might constitute market misconduct.
- ▶ The term “**officer of a corporation**” includes a **director** (including a **shadow director** and any person **occupying the position of a director**), manager or secretary of, or any other person involved in the management of, the corporation (Schedule 1 SFO). Persons involved in management could catch supervisors and anyone else with management responsibilities

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Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

▶ Sanctions for civil offence

The MMT may impose any of the following orders on an officer of a corporation found to have committed market misconduct:

- *disqualification order*
- *cold shoulder order*
- *cease and desist order*
- *disgorgement order*
- *Government costs order*
- *SFC costs order*
- *disciplinary referral order*

Failure to comply with a disqualification, cold shoulder or cease and desist order is a criminal offence punishable by a maximum fine of \$1 million and/or up to 2 years' imprisonment.

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Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

▶ Criminal liability

- No double jeopardy - a person cannot face both civil and criminal prosecution for the same conduct
- Maximum criminal sanctions:
 - * Up to 10 years' imprisonment
 - * Fine of up to HK\$10 million

▶ Criminal liability of officers

- Where it is proved that an offence committed by a corporation under Part XIV SFO was aided, abetted, counselled, procured or induced by, or committed with the consent or connivance of, or attributable to the recklessness of, any officer of the corporation, or any person purporting to act in any such capacity, that person, as well as the corporation, is guilty of the offence and liable to be punished accordingly (s390 SFO).

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Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

▶ **Civil liability to persons who have suffered loss**

* An officer of a corporation who has committed market misconduct may also be liable to pay damages to any person who has suffered financial loss as a result of the market misconduct or any other offence under Part XIV SFO. The perpetrator is liable to pay damages, unless it is fair, just and reasonable that he should not (Sections 281 and 305 SFO).

▶ **A person will be taken to have committed market misconduct if:**

- a. he has perpetrated any market misconduct;
- b. the market misconduct was perpetrated by a corporation of which he is an officer with his consent or connivance; or
- c. any other person committed market misconduct and he assisted or connived with that person in the perpetration of the market misconduct, knowing that such conduct constitutes or might constitute market misconduct.

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Five areas of potential civil and/or criminal liability (Cont'd)

C. Market misconduct

▶ Officers' duty to prevent corporation perpetrating market misconduct

- * Section 279 SFO imposes a duty on all officers of a corporation to take reasonable measures to ensure that proper safeguards exist to prevent the corporation from acting in a way which would result in the corporation perpetrating any market misconduct
- * Where a corporation has been identified as having been engaged in market misconduct and the market misconduct is directly or indirectly attributable to a breach by any person as an officer of the corporation of the duty imposed on him by Section 279, the MMT may make one or more of the orders detailed above in respect of that person even if that person has not been identified as having engaged in market misconduct himself.
- * However, a breach of the Section 279 duty will not expose a person to civil suits by third parties unless he has been identified as having engaged in market misconduct.

Five areas of potential civil and/or criminal liability (Cont'd)

D. False disclosure filed with the Exchange and/or the SFC

- ▶ s384 SFO imposes criminal liability on any person who intentionally or recklessly provides any information which is false or misleading in a material particular in filing with the SFC or the HKSE **a prospectus, other listing document or any public disclosure materials** disseminated under the Hong Kong Listing Rules.
 - * In practice, listing applications and all on-going public disclosures are filed with the SFC by the HKSE, the listing applicant having authorized it to do so in its listing application form (Form A1).
 - * An offence under s384 carries maximum penalties of 2 years' imprisonment and a fine of HK\$1 million.

Five areas of potential civil and/or criminal liability (Cont'd)

E. Section 214 SFO

- ▶ Where, in relation to a corporation which is or was listed, it appears to the SFC that the business or affairs of the corporation have been conducted in a manner which is:
 - a) oppressive to its members or any part of its members
 - b) involving defalcation, fraud, misfeasance or other misconduct
 - c) resulting in its members or any part of its members not having been given all the information that they might reasonably expect or
 - d) unfairly prejudicial to its members or any part of its members

the SFC can apply to the court for a wide range of orders. These include:

- a) an order for the corporation to bring proceedings against the persons and on the terms specified by the court;
- b) a disqualification order (prohibiting involvement in company management) against an officer for up to 15 years; or
- c) any other order it considers appropriate.

Rontex International Holdings Limited - in 2010, the SFC obtained disqualification orders and an order that the corporation bring legal proceedings against its former officers for compensation.

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Disciplinary Sanctions imposed by the Exchange

- ▶ If a listed company and/or its directors are found to have breached the Listing Rules, the Exchange may impose the following disciplinary sanctions on the director or the company:
 - suspend or cancel the listing of the company;
 - issue a private reprimand;
 - issue a public statement which involves criticism;
 - issue a public censure;
 - report the offender's conduct to the SFC or another regulatory authority or to an overseas regulatory authority;
 - in the case of willful or persistent failure by a director of a listed issuer to discharge his responsibilities under the Listing Rules, state publicly that in the Exchange's opinion the retention of office by the director is prejudicial to the interests of investors; after the issuance of the public statement, if the director remains in office, the Exchange may suspend or cancel the listing of the company's securities.

Removal of directors

A company can remove a director by ordinary resolution notwithstanding any provision of the company's memorandum or articles of association or any contractual provision. s157B expressly clarifies that it will not deprive a person removed as a director of compensation or damages.

Procedure (s157B CO)

- a. Special notice of a resolution to remove a director from office must be given by a member of the company to the company **at least 28 days before** the proposed general meeting;
- b. On receipt of the special notice, the company must send a copy of the notice to the director in question. On receipt of the notice, the director may make a written statement / representations and request the company to circulate the same to members of the company;
- c. The company must dispatch the notice of general meeting to members of the company and the director at least 21 days before the meeting (s116C CO). If the director has made written representations, the notice must also specify that such representations have been made and a copy of the written representations must be attached to the notice;

Removal of directors (Cont'd)

Procedure (s157B CO)

- d. If the director's written representations have not been circulated to company members because they were received too late or the company failed to circulate, the director may request that the written representations be read out at the general meeting;
- e. After the passing of the ordinary resolution in general meeting, the company must submit a completed and signed Form D2A to the Companies Registry within 14 days after the date of removal of the director.

Listing Rule Requirement

- ▶ *Under LR13.51(2), a listed company must publish an announcement of the removal of a director including **the reasons** given by or to the director for the removal. This includes, but is not limited to, any information relating to his **disagreement with the board** and a statement whether or not there are any matters that need to be brought to the attention of holders of the company's securities.*

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Removal of directors (Cont'd)

Compensation for loss of office (s163 – s163D CO)

- A bona fide payment to a director **by way of damages** for breach of contract or by way of pension in respect of past services does not require the approval of the company in general meeting or disclosure of full particulars of the payment (S163(D) CO)
- However, other payments for loss of office must be **disclosed** to members and **approved** by the members in general meetings
- Otherwise, the payment is **illegal** and the director in receipt of payment is deemed to have received the payment **in trust** for the company or the persons who have sold the shares.

Removal of directors (Cont'd)

Compensation for loss of office (s163 – s163D CO)(Cont'd)

Payments requiring disclosure to members and approval by members in general meeting

- a. Payment by way of **compensation for loss of office** or in connection with retirement from office as director of the company or of any subsidiary company or any other office concerned with the management of the company's or a subsidiary's affairs (section 163);
- b. Any payment described in (a) above, where the whole or any part of the **undertaking or property** of the company is being transferred (section 163A); and
- c. Any payment described in (a) above, where all or any of **the company's shares** are being transferred as a result of:
 - * An offer made to the general body of shareholders; or
 - * An offer made by a company with a view to establishing a holding-subsidary relationship; or
 - * An offer made by an individual with a view to obtaining control of at least one-third of the voting power at any general meeting of the company; or
 - * Any other offer which is conditional on acceptance to a given extent (section 163B).

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Removal of directors (Cont'd)

Compensation for loss of office (s163 – s163D CO)

- In relation to (b) and (c) above, any payment made under any arrangement **within one year before or two years after** the transfer is deemed to be included as part of the compensation mentioned in (a)
- if the director's shares are purchased at a rate greater than other shareholders could have obtained or any non-cash consideration is given to a director, the excess of the share price or the money value of the consideration is deemed to be a payment by way of compensation

Removal of directors (Cont'd)

- ▶ Executive directors often protected by long term employment contracts
- ▶ High cost of compensation can make it expensive for shareholders to remove directors
- ▶ UK Companies Act requires express approval of a company in general meeting for any arrangement giving a director a fixed term contract of >5 years
- ▶ No comparable provision in HK Companies Ordinance – but Listing Rules require prior approval of shareholders in general meeting for any service contract to be granted by a listed company or any of its subsidiaries to a director which:
 - Is for a duration that may exceed 3 years
 - In order for the company to terminate the contract, requires the giving of more than one year's notice or payments equivalent to more than one year's emoluments (Rule 13.68).

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