Directors’ Roles and Responsibilities - Dealing With Dysfunctional Boards, Crises & Emergencies

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DIRECTORS’ ROLES AND 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

Directors’ duties have various sources, including the constitution of the company, common law and statute law.

Under the Companies Ordinance and the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong (the “Listing Rules”), the term “director” includes any person who occupies the position of a director by whatever name called. Under the Companies Ordinance, a director includes a “shadow director” being a person in accordance with whose directions or
instructions the directors or a majority of them are accustomed to act.

Although common law sets out and elaborates on most of the major principles of directors’ duties, it tends to be complex and inaccessible. The Companies’ Registry has published “A Guide on Directors’ Duties” setting out the non-statutory duties of a director applicable to the directors of all companies, listed and unlisted.

The general duties of directors are:

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

The non-statutory duties set out in the Guidelines are not exhaustive.

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**Directors’ Fiduciary Duties (Cont’d)**

The Listing Rules also impose these requirements on all Hong Kong listed companies regardless of their place of incorporation. Rule 3.08 requires listed company directors, collectively and individually, to fulfill fiduciary duties and duties of skill, care and diligence to a standard at least equivalent to that required under Hong Kong law. The Listing Rules also make the company’s board collectively responsible for its management and operations.

Amendments to the Listing Rules which came into effect in January 2012 clarified that while directors may delegate their functions, this does not absolve them from their responsibilities or from using appropriate levels of skill, care and diligence. As an absolute minimum, 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.

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**Five areas of potential civil and/or criminal liability**

A **Fraudulent trading (s275 Companies Ordinance)**
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.

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

B New statutory regime for disclosure of price sensitive information (“PSI”)

A new statutory regime governing listed corporations’ (“corporations”) disclosure of PSI (referred to in the new legislation as "inside information") will come into effect on 1
January 2013. The regime is set out in a new Part XIVA to the Securities and Futures Ordinance (“SFO”).

The amended SFO will use the term “inside information” to refer to the PSI which a corporation must disclose. “Inside information” will be defined in Section 307A SFO as:

Specific information that:

(a) is about:
   (i) the corporation;
   (ii) a shareholder or officer of the corporation; or
   (iii) the listed securities of the corporation or their derivatives; and

(b) 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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Timing of Disclosure: section 307B(1) SFO
Section 307B(1) SFO requires a corporation to disclose PSI to the public as soon as reasonably practicable after any inside information has come to its knowledge. For these purposes, inside information has come to the corporation’s knowledge if:
(a) 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

(b) 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).

Corporations must therefore ensure that they have effective systems and procedures in place to ensure that any material information which comes to the knowledge of any of their officers is promptly identified and escalated to the board to determine whether it needs to be disclosed.

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**Definition of “officer”**

The term “officer” is defined widely to include a director, manager or secretary of a corporation or any other person involved in its management (Part 1 of Schedule 1 to the SFO). According to the SFC’s Guidelines on Disclosure of Inside Information, a manager will usually mean a person who, under the immediate authority of the board, has responsibility for the whole, or a substantial part, of a corporation’s business.
Under the amended SFO, the Securities and Futures Commission (the “SFC”) will be able to directly institute proceedings before the Market Misconduct Tribunal (the “MMT”) to enforce the PSI disclosure requirement.

The MMT will be able to impose one or more of the following penalties:

(a) a fine of up to HK$8 million on the corporation, a director or chief executive (but not officers) of the corporation;

(b) disqualification of a director or officer from being a director or otherwise involved in the management of a corporation for up to five years;

(c) a “cold shoulder” order on the director or an officer (i.e. the person is deprived of access to market facilities for dealing in securities, futures contracts and other investments) for up to five years;

(d) a “cease and desist” order on the corporation, a director or officer (i.e. an order not to breach the statutory disclosure requirement again);

(e) an order that any body of which the director or officer is a member be recommended to take disciplinary action against him; and
(f) payment of costs of the civil inquiry and/or the SFC investigation by the corporation, director or officer.

A corporation or officer found to be in breach of the statutory 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 brought by such person under Section 307Z SFO.

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**Potential Liability of Officers**

Section 307G(1) SFO imposes an obligation on a corporation’s officers to take all reasonable measures to ensure that proper safeguards exist to prevent the corporation’s breach of the PSI disclosure requirement.

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).
The SFC’s Guidelines on Disclosure of Inside Information emphasize the obligation on officers, including non-executive directors, to ensure that appropriate systems and procedures are put in place and reviewed periodically to enable the corporation to comply with the disclosure requirement. They further provide that 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.

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

C. Market Misconduct

Parts XIII and XIV of 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.
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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.
Civil proceedings for market misconduct are brought before the Market Misconduct Tribunal and their purpose is to determine:

a. whether any market misconduct has taken place;

b. the identity of every person involved in the market misconduct; and

c. 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:

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. 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. Persons involved in management could catch supervisors and anyone else with management responsibilities.

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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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Criminal liability
There is no double jeopardy - a person cannot face both civil and criminal prosecution for the same conduct.

The maximum criminal sanctions that can be imposed are:

- Up to 10 years’ imprisonment
- A 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 (Section 390 of the SFO).

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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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**Officers’ Duty to Prevent Corporation Perpetrating Market Misconduct**

Section 279 of the 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.

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

Section 384 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. Listed companies are required to file with the SFC any public disclosure that they disseminate under the Listing Rules, including announcements, circulars, statements and other documents by Rule 7 of the Securities and Futures Stock Market Listing Rules. In practice, listing applications and on-going public disclosures are filed with the SFC by the HKSE, the company 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.

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E Section 214 SFO

Under Section 214 SFO, the SFC can apply to the court for the imposition of a wide range of orders if it considers that the business or affairs of a listed corporation have been conducted in a manner:

(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) which is unfairly prejudicial to its members or any part of its members.

The orders which can be imposed by the court include:

(a) an order for the corporation to bring proceedings considered appropriate by the court 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.

In the case of 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. The court ordered the company to sue 3 of its directors for damages for: (a) breach of fiduciary duties; breach of disclosure obligations under the Listing rules; and (c) conduct unfairly prejudicial to the interest of shareholders in entering various transactions which resulted in a loss of HK$19 million. The SFC alleged that Rontex failed to utilize the proceeds derived from its listing (approx. HK$28.8 million) in accordance with representations made in its listing document. Specifically, Rontex failed to invest the IPO proceeds in furtherance of its baby garment manufacturing business.

Orders can be imposed on both current and former officers of a listed company under section 214. In 2012, the court ordered former executives of a listed company to pay compensation to the company under section 214 for the first time. The former chairman and a former executive director of Styland Holdings Ltd were ordered to pay over HK$85 million in compensation to the company for entering into transactions that were not in the company’s interests but which directly or indirectly benefitted the executives. They were also each disqualified from becoming company directors for 12 years.
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Disciplinary Sanctions available to the HK Stock 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 directors or the company:

1. suspend or cancel the listing of the company;
2. issue a private reprimand;
3. issue a public statement which involves criticism;
4. issue a public censure;
5. report the offender’s conduct to the SFC or another regulatory authority or to an overseas regulatory authority; or
6. 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.

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Removal of directors

Section 157B of the HK Companies Ordinance provides for a company to remove a director by ordinary resolution
notwithstanding any provision of the company’s memorandum or articles of association or any provision of an agreement between the director and the company. s157B expressly clarifies that it will not deprive a person removed as a director of compensation or damages.

Section 157B requires special notice to be given of a resolution to remove a director from office – so that a shareholder must give notice to the company of the proposed resolution at least 28 days before the general meeting at which the director’s removal will be proposed.

On receipt of the special notice, the company must forward a copy of the notice to the director in question. On receipt of such notice, the director may make a written statement or representations and request the company to circulate the same to members of the company.

The company must dispatch the notice of general meeting at which the removal resolution is moved to members of the company and the director at least 21 days before the meeting (section 116C of the Companies Ordinance). If the director has made written representations, the notice must also specify that such representation have been made and a copy of the written representations must be attached to the notice;

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If the director’s written representations have not been circulated to shareholders either because they were received
too late or because the company failed to circulate them, the
director may request that the written representations be read
out at the general meeting.

After the passing of an ordinary resolution to remove a
director in the general meeting, the company is required to
submit a completed and signed Form D2A to the Companies
Registry within 14 days after the date of the director’s
removal.

In the case of HK listed companies, Listing Rule Under
13.51(2) requires the company to publish an announcement
of the removal of the director as soon as practicable. The
announcement must include the reasons given by, or to, the
director for the removal. This includes, but is not limited to,
any information relating to his/her 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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Compensation for loss of office

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, including superannuation allowance, gratuity, or
other similar payment, does not require the approval of the
company in general meeting and no disclosure is required of
particulars of the payment (s163D (3)(b) of the Companies Ordinance).

However, other payments for loss of office must be disclosed to members and approved by the members in general meeting by virtue of s163C(1) of the Companies Ordinance. 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.

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The following payments must be disclosed to members and approved by them 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;

b. Any payment described in (a) above, where the whole or any part of the undertaking or property of the company is being transferred; 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-subsidiary 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.

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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). Also, 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 mentioned in (a) above, thus requiring disclosure of full particulars and the approval of the company in general meeting.

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Removal of directors

Notwithstanding shareholders’ nominal ability to remove directors, executive directors are often protected by long term employment contracts. In practice, therefore the
compensation payable to directors on their removal often acts as a deterrent to shareholders exercising their power to remove them. In the UK, the Companies Act requires express approval of a company in general meeting for any arrangement giving a director an effective fixed term contract of more than 5 years.

There is no comparable provision in HK Companies Ordinance, but the Listing Rules require the 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; or

- requires the giving of more than one year’s notice or payments equivalent to more than one year’s emoluments in order for the company to terminate the contract (Listing Rule 13.68).