MLS / Company Secretary

RECENT DEVELOPMENTS IN DIRECTORS' DUTIES IN HONG KONG

1 INTRODUCTION

In Hong Kong, the responsibilities and liabilities of directors derive from the following sources:

1. Articles of association of the company;
2. Common law; and
3. Legislation, in particular the Companies Ordinance (Chapter 622 of the Laws of Hong Kong) (**CO**).

Since the implementation of the CO, there have been developments in directors' duties in Hong Kong. In this memo, we will summarize and briefly explain these developments, and then move on to provide a more general summary of directors' duties.

2 TREND – INCREASE IN STATUTORY DERIVATIVE ACTIONS

In recent years, there has been a growing number of statutory derivative actions alleging breach of a fiduciary's duties to the company[1]. A derivative action is where the shareholder brings an action for and on behalf of the company. This trend shows that there has been an increased awareness of director's duties and the rights that shareholders have against directors. It is therefore very important for directors to know their duties in order to avoid potential claims.

3 RECENT CASE LAW ON FIDUCIARY DUTIES

We will briefly explain and summarize recent case law which illustrate the nature and extent of directors' duties in Hong Kong.

3.1 Conflict of interest and purposive diversion of business – Law Kwok Kei v Vicky Siu Wing Kee & Others [2014] HKCU 2335

Facts:
In that case, a shareholder of the company brought a derivative action for a company called HK Fullson Ltd (**Fullson**). The action was brought against one of the directors (**Siu**) for breach of fiduciary duty by diverting the business from Fullson to his related company in the same line of business (**Intelli**) and for wrongful use of Fullson's property (use of the factory premises of Fullson without authorization). Fullson was later wound up.

Siu was previously a shareholder of Intelli but subsequently transferred his shareholding to his daughter (**Vicky**). Vicky then became a director of Intelli while she was employed by Fullson. The shareholder also brought a derivative action against Vicky for dishonestly assisting Siu to breach his fiduciary duties as a director of Fullson, since it was alleged that she was the person who actively engaged in the diversion of business.

[1] Félix E. Mezzanotte (2017), "The unconvincing rise of the statutory derivative action in Hong Kong: evidence from its first 10 years of enforcement", Journal of Corporate Law Studies, 17:2, 469-496, DOI: 10.1080/14735970.2017.1285548.

Decision:

The court held that Siu acted in breach of his fiduciary duties by operating (and having shareholding in) Intelli, which was in the same line of business as Fullson, and by operating the business of the factory. It was ordered that Siu should account for all profits that he made as a result.

Additionally, it was held that Vicky and Intelli were both liable for dishonestly assisting Siu for breach of his fiduciary duties. Vicky and Intelli were both ordered to account for the profits made as a result of the assistance. Amongst others, the court took into account:

1. Her actual role in Fullson;
2. The evidence provided where it was shown she actually positively diverted business away from Fullson;
3. Her educational background and her experience in business; and
4. Intelli is equally liable to account on the same basis as Vicky since she was the director responsible for the relevant area of activities of Intelli and her state of mind was attributed to Intelli.

Key takeaways:

- ✓ The court highlighted in that case the fact that a director owes fiduciary duties to a company of which he is a director.
- ✓ It is important to note that a director has strict liability (meaning there is no need for there to be ill-will or dishonesty) not put to himself in a position where his self-interest conflicts with the duties he owes to the company (typical examples of which would be to carry on a business in the same line or area as the company, or to take customers from the company). If a director does this, he would be under a liability to account for the profits he has made by reason thereof.
- ✓ A director may only keep his profits if he has obtained the shareholder/company's informed consent after making full disclosure.
- ✓ A director is liable as a trustee for any misapplication of the company's property that he participated in, new about or ought to have known about. Therefore, directors need to be prudent about the activities of the company.
- ✓ Third parties who dishonestly assist a director to act in breach of his fiduciary duties would also be liable to compensate the company for any loss that the shareholder/company suffered, or to account for any profit that he has made as a result of this assistance. To claim against somebody for this, you will need to prove that the person was dishonest.

3.2 Multiple directorships and the extent of the duty of loyalty – Poon Ka Man Jason & Others v Cheng Wai Tao & Others [2016] HKCFA 23

Facts:

This case was about three siblings, Jason Poon, Daisy Poon and Ricky Cheng (**Ricky**) who were business partners of a restaurant group in Hong Kong (**Ajisen**) in Hong Kong, which initially operated noodle restaurants. Ajisen set up a company called Smart Wave Ltd (Smart Wave) which opened one sushi restaurant, Ricky began to operate and expand his own brand of sushi restaurants on his own using a company in which he was both the sole director and sole shareholder, even though the partners had agreed to develop a chain of Japanese-style sushi chains as an extension of the existing Ajisen business.

By way of background, the business model of Ajisen is to have one company for one operation. Therefore, the court also considered whether Ricky's conduct was outside the scope of his fiduciary duties owed to the Smart Wave has been breached. It was also considered whether or not there was agreement or assent from the shareholders as to whether Ricky could expand and operate other sushi restaurants on his own, given the limited nature of the operation of each company within the Ajisen Group.

Decision:

It was held by the court that Ricky was in breach of his fiduciary duties to Smart Wave.

Although the business of Smart Wave was of a limited nature, it was the first of a chain of restaurants and so had an interest in the establishment and operation of the chain as it developed. The court's rationale was that the setting up of additional companies by Ricky which ran a business in competition with Smart Wave diverted business opportunities and profits away from Smart Wave to its detriment.

Key takeaways:

- ✓ There are potential difficulties with the no-conflict rule when a director has multiple directorships and shareholdings. Directors should take particular care where their shareholdings and directorships are in conflicting businesses.
- ✓ Even where there is room for argument about the duty of loyalty, the court may still hold that directors have breached their duties, especially where there has been diversion of business. Directors should be particularly aware of this.
- ✓ The scope of fiduciary duties can be modified, but this would require unanimous assent of the shareholders of the company. It would be better to have this agreement in signed writing.

4 THE GENERAL PRINCIPLES OF DIRECTORS' DUTIES

It is important for directors to be clear about the exact extent of their responsibilities because they may be liable to civil and/or criminal proceedings and may be disqualified from acting as a director if they fail to meet the requirements.

Directors are also encouraged by governmental bodies to refer to more detailed reviews of the role and duties of directors in law. For example, the Hong Kong Institute of Directors has issued Guidelines for Directors. The Hong Kong Exchanges and Clearing Limited (**HKEx**) has also issued a Corporate Governance Code to help improve the way in which listed companies are managed.

We have briefly set out below some general principles relating to directors' duties for your information[2].

Principle 1: Duty to act in good faith for the benefit of the company as a whole - Re Smith & Fawcett Ltd [1942] Ch 304 and Bishopsgate Investment Management Ltd v Maxwell (No 2) [1994] 1 AII ER 261

1. A director of a company must act in good faith in the best interests of the company (i.e. best interests of all its shareholders, present and future).
2. A director must as far as practicable have regard to the need to achieve outcomes that are fair as between its members.

[2] This section is based on "A Guide on Directors' Duties" published by the Companies Registry in March 2014.

Principle 2: Duty to use powers for a proper purpose for the benefit of members as a whole - Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821

1. A director must exercise his powers for a 'proper purpose' – i.e. he must not exercise his powers for purpose that are different from those for which they were conferred.
2. The primary and substantial purpose of the exercise of a director's powers must be for the benefit of the company.
3. If the primary motive of an exercise of power is found to be for some other reasons (e.g. to benefit one or more directors and to gain control of the company), then the effects of the director's exercise of power may be set aside.
4. This duty can be breached even if the director has acted in good faith.

Principle 3: Duty not to delegate powers except with proper authorization and duty to exercise independent judgement

1. Unless authorized to do so by the company's articles of association, a director must not delegate any of his powers.
2. A director must exercise independent judgement in relation to any exercise of his powers.

Principle 4: Duty to exercise care, skill and diligence

1. This duty is provided for by Section 465 of the Companies Ordinance.
2. The standard used for determining whether a director has exercised care, skill and diligence is that of a reasonably diligent person with:
   i. The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions of a director of the company; and
   ii. The general knowledge, skill and experience that the director has.

Principle 5: Duty to avoid conflicts between personal interests and interests of the company - Aberdeen Railway Co v Blaikie Bros [1854] 1 Macq. 461, 471

1. A director must not allow personal interests to conflict with the interests of the company.

Principle 6: Duty not to enter into transactions in which the director(s) have interest except in compliance with the requirements of the law

1. A director of a company has certain duties where he has a material interest in any transaction to which the company is, or may be, a party.
2. Until he has complied with these duties, a director must not, in the performance of his functions as a director, authorize, procure or permit the company to enter into a transaction.
3. A director must not enter into a transaction with the company unless he has complied with the requirements of the law. The law requires a director to disclose:
   i. The nature and extent of his interest in request of interested transactions;
   ii. Under certain circumstances, the constitution may prescribe procedures to secure the approval

5 ADDITIONAL SOURCES OF INFORMATION

1. Companies Registry, "A Guide on Directors' Duties" (March 2014);
2. The Hong Kong Institute of Directors, "Guidelines for Directors", 4th ed. (2014);
3. The Hong Kong Institute of Directors, "Guidelines on Corporate Governance for SMEs in Hong Kong", 3rd ed. (2014);
4. The Hong Kong Institute of Directors, "SME Corporate Governance Toolkit" (2009);
5. HKEx, Listing Rules, Interpretation and Guidance – Appendix 14 to the Main Board Listing Rules (Corporate Governance Code and Corporate Governance Report).

This memo is for your general reference only is not intended to be legal advice.