

Directors' failure to exercise independent judgment and make reasonable enquiries will lead to serious consequences as demonstrated in recent section 214 cases

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Introduction

The Court of First Instance (the **Court**) has recently sanctioned a number of directors of listed companies by way of disqualification orders pursuant to section 214 of the Securities and Futures Ordinance. These latest cases serve to remind directors that failure to exercise reasonable care, skill and diligence as required under their directors' duties may lead to serious consequences (both professionally and financially). This is so even if no dishonesty, bad faith, illicit gain or conflict of interest is involved.

Recent disqualification cases

In *SFC v Kwok Wing and Others* [2019] HKCFI 2322, a former executive director of Tack Fat Group International Limited (renamed Tack Fiori International Group Limited on 23 November 2011 and Life Healthcare Group Limited on 26 May 2017) (**Tack Fat**) was disqualified for six years as a result of her breaches of director's duties. In summary, she was found to have been involved in the following misconduct:

- Without making any independent inquiry as to the purpose and the company's ability to repay, she signed various documents approving and causing Tack Fat to borrow loans totalling HK\$98 million by pledging its assets. She also failed to take steps to cause Tack Fat to disclose information concerning those loans which constitutes "price sensitive information".
- Without exercising independent judgment or making any reasonable inquiry, she approved a grant of share options to two employees of Tack Fat, who were found to have been acting as nominees of the chairman of the board.

- She signed board meeting documents which approved an acquisition of interests in a foreign company without knowing details about it, including the nature and purpose of the transaction and the parties involved. It was subsequently discovered that the seller was the chairman's nominee and the transaction constituted a connected transaction.
- She failed to ensure that the company maintains a proper financial management system.

Prior to this decision, the SFC had already obtained disqualification orders against two other former executive directors of Tack Fat, who were also involved in approving the said transactions, both of them were disqualified from being a director for 6 years.

Similarly, in *SFC v Wong Yuen Yee & Others* [2019] HKCFI 2463, the Court disqualified four former executive directors of Inno-Tech Holdings Limited (**Inno-Tech**) for three years in relation to Inno-Tech's acquisition of interests in three hotels in the Mainland (the **Acquisitions**). The Acquisitions turned out to be disastrous investments, which resulted in an aggregated loss of 32.8 million RMB. The conduct of the four former executive directors (the **Directors**) complained of include:

- The Directors failed to carry out adequate due diligence prior to the Acquisitions. In particular, in delegating the decision on whether to proceed with the Acquisitions to a team of staff responsible for hotel management in the PRC, the Directors failed to properly supervise the team and to ensure that proper due diligence was conducted.

- In deciding whether to go ahead with the Acquisitions, the Directors did not adequately consider the value of the properties of the three hotels. They failed to give any consideration to the profitability and prospect of business at the hotels.
- Apart from obtaining some draft valuation reports from a valuer, the Directors failed to negotiate the consideration for the Acquisitions, either at arm's length or at all.

Lessons for directors

In the cases above, failures by directors to exercise independent judgment and/or make reasonable inquiries into a matter to be decided were held to be in breach of their directors' duties to exercise reasonable care, skill and diligence. Even where the decision was delegated to a particular person/team within the company, the directors' indifference towards that decision and/or failure to supervise such person/team could also constitute a breach.

Even if you are a non-executive director of a listed company, you shall always perform your functions as designated in the Corporate Governance Code, which include:

- “participating in board meetings to bring an independent judgement to bear on issues of strategy, policy, performance, accountability, resources, key appointments and standards of conduct;
- taking the lead where potential conflicts of interests arise;
- serving on the audit, remuneration, nomination and other governance committees, if invited; and
- scrutinising the issuer's performance in achieving agreed corporate goals and objectives, and monitoring performance reporting.”

Trends of enforcement

It can be seen that the SFC and the Court are taking an increasingly active approach in sanctioning listed company directors involved in misconduct. If a director is found to have acted in breach of his duties to the company, the director could face dire consequences including disqualification orders, or even compensation orders in some cases.

The devastating effect of a disqualification order is to ban the relevant person from being a director or taking part, directly or indirectly, in the management of any listed or unlisted company in Hong Kong for up to 15 years. The disqualification could also extend to restraining the person from being involved in the management of any subsidiary or affiliate of a company. This can be the case even where the director is not the main culprit of the misconduct, gains no personal benefit from it and has no bad faith.

It is worth noting that in the recent legal proceedings initiated by the SFC against Perfect Optronics Limited's chairman and board members, the SFC is seeking both disqualification and compensation orders against the directors. If successful, on top of being disqualified, the directors will also be compelled to compensate Perfect Optronics Limited for the alleged loss caused by their misconduct.

Conclusion

It is clear that the SFC will not tolerate director's misconduct and will continue to pursue court proceedings to hold listed company directors accountable for their actions (or inactions). Listed company directors must properly discharge their duties to the companies to avoid the potentially devastating consequences of section 214 court proceedings.

Should you wish to discuss the above, please contact any of those listed below or your usual Slaughter and May contact.



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