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DUTIES OF DIRECTORS WHEN COMPANIES START TO EXPERIENCE FINANCIAL DISTRESS

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Amidst the challenges posed by COVID-19 on businesses worldwide, companies in many sectors are experiencing sharp drops in revenue. Some are even facing a complete halt to their businesses. Both situations may raise the prospect of a business becoming insolvent (or at least receiving requests from creditors for repayments and there may be uncertainty as to whether these requests can be met). In this briefing, we explore some of the issues that should be considered by directors of a company for which insolvency is a possibility. These considerations are pertinent to directors not only of Hong Kong-incorporated companies but also to those of non-Hong Kong companies listed on the Hong Kong Stock Exchange (the **Exchange**) and their subsidiaries.

Directors' duties: potential conflicts and points to note

Directors (whether executive or non-executive directors) of Hong Kong-incorporated companies and Hong Kong listed companies alike are under the obligation to exercise reasonable care, skill and diligence[1]. Their conduct must meet the standard of a hypothetical reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function for the company in the same circumstances (which is an objective test). The directors must also use their own general knowledge, skills and experience in carrying out their duties. If a director possesses a higher level of skill in a particular area (e.g. has a professional qualification in accounting or law), his conduct will also be measured subjectively by reference to his own skills.

Under common law, when a company is solvent, its directors' primary duties are owed to its shareholders as a whole, in order to promote the company's financial success and the fulfilment of its other objectives. However, if a company's financial situation deteriorates, the interests of the company's creditors become more important. The question of balancing these respective interests when conflicts arise would therefore be critical when times are difficult.

When a group is in financial distress, its ultimate shareholder would no longer be the primary economic beneficiary of the group. Creditors will be left with claims to recover debts against the individual companies within the group they are contracted to, not the group as a whole. It would not be up to the ultimate shareholder to decide how to allocate

[1] As required respectively by s.465 of the Companies Ordinance (**CO**) (Cap. 622) and Rule 3.08 of the Listing Rules.

the assets and liabilities amongst the group companies. The board of each individual company within the group will be obliged to consider the interests of its creditors, rather than looking to serve the overall interests of the parent company. Further, they owe their duties to the company of which they are a director, rather than the group as a whole. Therefore, directors will have to be cautious when considering and approving any financial assistance to be given to another group company which does not have sufficient assets to repay its indebtedness, even if such financial assistance would help keep the other group company or even the entire group afloat and would be in the best interest of the ultimate shareholder. The directors always have to analyse the matter at the individual board level with regard to the circumstances of their individual company.

If a person serves simultaneously as a director in multiple companies within the group, the effect of this conflict becomes even more immediate.

Directors increase their risk of liability if they are unable to demonstrate that they have considered their duties and responsibilities on a company-by-company basis. Key decision makers within the group, such as shareholders and the directors of parent company boards, can also face claims as 'shadow' or 'de facto' directors in connection with actions taken at the subsidiary level if they exert too much control over those boards.

Risks of continuing to trade

Apart from the potential conflicting duties, directors should also be mindful of the risks associated with continuing to trade whilst a company is in financial difficulties. Doing so might lead to consequences under Hong Kong's insolvency regime.

Fraudulent trading

Unlike England and Wales, Hong Kong's insolvency law has yet to introduce the concept of 'insolvent trading' (see below). Nevertheless, directors (and other persons who are knowingly party to it) may be liable for fraudulent trading if, in the course of the winding up of a company, it appears that they had conducted the business of the company with an intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose[2]. An example would be that a director knowingly causes an insolvent company to transfer its assets to a related party so as to preserve those assets from the creditors.

Notably, according to English case law, in establishing a person is 'knowingly party' to fraudulent trading, it is not necessary to prove that he had a direct intent to defraud the creditors or that he was aware of the company's insolvency. It is sufficient to prove that he turned a blind-eye to it – i.e. where he deliberately abstained from enquiry in order to avoid the knowledge of fraudulent trading which he already suspected to be the case[3]. Therefore, even where a person (such as a non-executive director) may not be directly involved in the management or have actual knowledge of the affairs of the insolvent company in question, he could still be held liable for fraudulent trading where he had grounds to suspect that was the case and took no active interest in the affairs of the company.

[2] See s.275 of the Companies (Winding up and Miscellaneous Provisions) Ordinance (**CWUMPO**) (Cap. 32).

[3] Bank of India v Morris [2005] 2 BCLC 328.

Where a person is found to be knowingly party to fraudulent trading, the court may, if it thinks proper to do so, declare that person to be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct. At the same time, the person could also be convicted of a criminal offence and liable to a fine (with no upper limit) and/or imprisonment of up to five years, as well as be subject to a disqualification order if he is a director.

Transaction at an undervalue and unfair preference

Directors should be cautious when continuing to trade in the midst of a company's financial difficulties as there are circumstances which could lead to transactions being set aside in the event that the company goes into liquidation.

Under s.265D of CWUMPO, when a company is in liquidation, the liquidator may apply to the court for an order to set aside transactions at an undervalue entered into by the company within five years before the commencement of its winding-up, provided that the company was insolvent at the time of the transaction or became insolvent as a consequence of the transaction. Transactions at an undervalue mean gifts or transactions where the company otherwise receives no consideration or receives consideration of a value which is significantly less than the consideration provided by the company.

In this regard, it is to be noted that according to English case law, dividends paid or distributed by a company to its shareholders are capable of coming within the definition of a "transaction" at an undervalue under s.423 of the Insolvency Act, even though it cannot be said to involve an agreement or arrangement between the company and the shareholders[4]. If the English law position is followed by the Hong Kong courts, it is likely that a dividend can potentially be declared void under s.265D of CWUMPO. This is not to mention that there are other restrictions under the CO regarding making a distribution where there are insufficient profits available for distribution (hence making the distribution unlawful)[5] – i.e. any distribution (whether in cash or in kind) must be supported by sufficient distributable profits of the company. As such, where there are signs of financial distress in relation to the company, a director should be cautious in exercising his judgment as to whether to recommend a dividend distribution for that financial year to avoid challenges that the distribution is unlawful and/or constitutes a transaction at an undervalue. If a distribution is found to be unlawful, the directors involved might be held liable for breach of directors' duties and accountable for the losses suffered by the company (or creditors in an insolvency scenario).

Nevertheless, when considering whether a transaction should be set aside under s.265D, the court will consider the circumstances and will not make such an order if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and (at the time of the transaction) there were reasonable grounds for believing that the transaction would benefit the company.

On the other hand, a transaction could also be set aside where it appears that an unfair preference has been given to a creditor or a surety/guarantor for any of the company's

[4] BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112.

[5] s.297 of CO.

debts or liabilities. An unfair preference is given to a person if the company does anything (or suffers anything to be done) putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position that the person would have been in if the act concerned had not been done. Under s. 266 of CWUMPO, a liquidator can apply to the court to set aside an unfair preference given to a person who is connected to the company (otherwise than being its employee) within two years before commencement of the winding-up; or in any other case within six months before commencement of the winding-up. It does not matter whether the unfair prejudice is an arm's length transaction. Also, it is important to note that a director who has been involved in giving such unfair preference could potentially be sanctioned by a disqualification order.

Disqualification orders and other sanctions

In addition to the risk of incurring personal (civil or criminal) liabilities, directors should also be aware of the possibility of being disqualified where they are found to have been in breach of their duties or otherwise involved in improper management of an insolvent company.

Under Part IVA of the CWUMPO, where the conduct of an insolvent company's director (either taken alone or together with other directors) makes him unfit to be concerned in the management of a company[6], the court can make a disqualification order against him with the effect of prohibiting him from acting as a director or otherwise (directly or indirectly) taking part in the promotion, formation or management of a company for up to 15 years. When considering whether a director is 'unfit', the court will take into account (amongst other things) whether the director was in breach of his fiduciary duty and the extent of the director's responsibility for the causes of the company becoming insolvent and the company entering into any transaction giving preference (as discussed above)[7].

Further, where a director is found to be liable for fraudulent trading or otherwise convicted of an indictable offence in connection with the promotion, formation, management or liquidation of the company, the court can also make a disqualification order against him[8].

For Hong Kong listed companies, sanctions may also be imposed against both executive and non-executive directors who have been found to be in breach of their undertaking to the Exchange to comply to the best of their ability with the Listing Rules, which includes a duty to meet the standard established by Hong Kong law on fiduciary duties and duties of skill, care and diligence. Further, s.214 of the Securities and Futures Ordinance (**SFO**) gives the Securities and Futures Commission (the **Commission**) the power to apply for a disqualification order against a director of a listed company where it appears to the Commission that, amongst others, the business or affairs of the listed company have been conducted in a manner which involves defalcation, fraud, misfeasance or other misconduct towards it or its members. We previously published another client briefing in relation to the enforcement of s.214 - please see here.

[6] s.168H of CWUMPO.

[7] Fifteenth Schedule, Part II of CWUMPO.

[8] s.168E, 168G and 168L of CWUMPO.

Upcoming Reform

Reform of Hong Kong's insolvency regime has been long called for. A Bill which proposed to introduce a more flexible and contemporary regime, including a corporate rescue procedure, was first introduced in 2001. Despite rounds of public consultation being held in 2009 and 2013 respectively, the Bill has yet to be updated and re-filed with the Legislative Council. The latest expectation is that an updated Bill will be finalised for introduction in the first half of the 2020-2021 legislative session after a final round of public consultation.

Notably, amongst all the proposed changes, the Government intended to introduce a power for the liquidator to seek a declaration that a 'responsible person' (i.e. a director or a shadow director) of a company could be held liable for 'insolvent trading', in the circumstances where (i) the responsible persons knew or ought reasonably to have known the company was insolvent or that there was no reasonable prospect that the company could avoid becoming insolvent; and (ii) they failed to prevent insolvent trading. Where such a declaration is made, the responsible person could be personally held liable for the debts of the company which traded while insolvent.

Delegation of directors' duties

Lastly, whilst in general directors are allowed to delegate some of their duties as it will be functionally impossible for a board to perform all tasks themselves, they (both collectively and individually) retain ultimate responsibility to exercise their skill and independent judgment to bring about good corporate governance. This ultimate responsibility cannot be abrogated.

In particular, as regards to non-executive directors, whilst they do not run the company on a day-to-day basis, they must ensure that the company has in place proper and effective systems and controls to deal with potential risks and abnormalities of the company. Further, they should exercise their independent judgment and supervision over the decisions that the executive directors and managers propose to make, rather than trusting them blindly and rubber-stamping those decisions.

Conclusion

Directors, including non-executive directors, should always keep an eye on the financial well-being of the companies they manage during these difficult times. Some practical steps that directors should consider taking include:

- Constantly monitor the company's corporate affairs and policies and remain critical and inquisitive about the financial and business information they receive, maintain familiarity with the financial status of the company by regularly reviewing and understanding its financial statements, and ask questions and seek further information (including on cash flows, cash reserves and creditor positions), as necessary;

- Review potential conflicts among subsidiaries within the same group and follow these steps should finances be strained:

    - Conduct an early review of the group structure: assess whether cross-directorships are likely to give rise to any conflicts of interest if the financial situation deteriorates and/or a restructuring process proves necessary;

    - Seek separate independent legal advice if needed: assess whether the mandate of the company's existing legal and professional advisors (the same lawyers can often advise directors across the group) may mean that directors of individual companies within the group would need to obtain

separate independent legal advice regarding their personal liabilities; and

- Ensure decisions are documented at the correct board level: have good record-keeping in place to show that the directors have considered what was best for that company and its creditors instead of just acting on the basis of the instructions of the parent company or the interests of the wider group. This will provide protection for the directors concerned and will also reduce the risk if others within the corporate group are shadow or de facto directors.

- Where there are indications that the company may be heading into insolvency, be mindful of potential conflicts of duties that may arise in such situations and the risks in causing the company to trade as usual as discussed in this article;

- Directors of Hong Kong listed companies should also remain sensitive to the issue of whether the latest financial condition of the company would give rise to any disclosure obligations under Part XIVA of the SFO. For further discussions on the disclosure obligations, please refer to our earlier briefing here.

If you would like further information about the impact of COVID-19 on your business, please speak to your usual Slaughter and May contact.

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