SLAUGHTER AND MAY

Latest decisions relating to breaches of directors' duties

May 2020

In our recent client briefings[1], we discussed directors' duties, particularly when a company is in financial difficulty. The recent High Court decision on an action commenced by the Securities and Futures Commission (**SFC**) against the former senior management of Long Success International (Holdings) Limited (**Long Success**), pursuant to section 214 of the Securities and Futures Ordinance (**SFO**)[2], and the sanctions imposed by the Hong Kong Stock Exchange (**SEHK**) on the former directors of Champion Technology Holdings Limited (**Champion Technology**) and Kantone Holdings Limited (**Kantone**)[3] serve as a timely reminder of the standard that directors of Hong Kong listed companies are expected to observe when considering and approving significant transactions.

Long Success

On 22 April 2020, the High Court ordered that the former vice-chairman/executive director, three former independent non-executive directors and a former non-executive director of Long Success be disqualified from being a director or being involved in the management of any listed or unlisted corporation in Hong Kong, without leave of the court, for a period of two to five years[4].

Long Success was listed on the Growth Enterprise Market of the SEHK on 17 August 2000[5] and was originally engaged in the gaming and entertainment business. The group started operating at a loss in 2007. At the material time, the chairman of the group was Wong Kam Leong (**Chairman**).

The SFC found that in 2009, the Chairman entered into an agreement on behalf of Glory Smile Enterprises Ltd (one of Long Success' subsidiaries) (**Glory Smile**) to indirectly acquire 51% of the interests in a paper manufacturing company named Jining Gangning Paper Co Ltd (**Jining Gangning**) for the consideration of HK$190 million (which was settled by cash, convertible bonds and promissory notes issued by Long Success)[6]. The acquisition was unusual in a number of respects: (1) paper manufacturing was something Long Success had little experience or expertise in; (2) the acquisition, which was a very significant transaction and would have a substantial and

[1] See our publications dated 27 December 2019, 6 April 2020 and 22 April 2020

[2] SFC v Wong Kam Leong and Others [2020] HKCFI 606

[3] See the case here

[4] The action was brought against 13 members of the former senior management of Long Success. The decision concerned only 5 of them who admitted that they were in breach of directors' duties. The proceedings against the others are ongoing

[5] Trading of Long Success' shares was suspended on 3 December 2013 and never resumed before Long Success' listing status was cancelled by the SEHK on 19 October 2016

[6] Glory Smile acquired the entire equity interest of Mega Bright Investment Development Limited held by Chook which in turn owned 51% of Jining Gangning

potentially long-term impact on Long Success' financial position, was done at the time when Long Success had been operating at a loss for a number of years, and (3) limited due diligence had been conducted for the Board's consideration prior to the acquisition.

What's more, Chook Hong Shee (**Chook**), the seller, guaranteed to compensate Long Success if Jining Gangning failed to achieve a certain level of profit or recorded a loss for each of the financial years of 2010 and 2011. However, when Jining Gangning failed to meet the profit guarantee, instead of enforcing the rights against Chook, the Chairman, on behalf of Long Success and Glory Smile, entered into a series of confirmation letters, originally to postpone payment of the profit guarantee shortfall by Chook without interest, and eventually to forfeit Glory Smile's right to enforce the profit guarantee. It is notable that the Chairman relied on the force majeure clause in the acquisition agreement in agreeing to forfeit the shortfall balance to the amount of HK$30 million. In doing so, he ignored Long Success' Counsel's opinion that the various factors which were said to have caused profit reduction[7] would unlikely trigger the force majeure clause.

In October 2011, the Chairman caused two of Long Success' subsidiaries to guarantee his personal indebtedness of up to RMB20 million. Subsequently, the Intermediate People's Court of Zhongshan City held the two subsidiaries liable for the Chairman's obligation to repay RMB20 million, together with interest and a defaulting fee.

To make matters worse, when responding to the SEHK's enquiries as to whether Long Success or any of its subsidiaries had given any guarantee for the directors' or their associates' personal liabilities, the respondents confirmed that, having made all reasonable, due and careful enquiries, there was no such guarantee. The confirmation was clearly factually inaccurate.

The Court found that there was no objective, rational or commercial reason for Long Success or any of its subsidiaries to agree to forfeit the right to the profit guarantee shortfall without compensation or to guarantee repayment of the Chairman's personal indebtedness. These transactions were clearly financially detrimental to the companies, bearing in mind that the group had been making a loss. In fact, the group had had been having liquidity problems since 2012, possibly caused by these transactions. Whilst the current Board of Long Success took action to recover the profit guarantee shortfall from Chook, they only managed to recover approximately HK$100,000.

In considering the allegations against the respondents, the Court found that (1) the Chairman was able to dominate and control the affairs of Long Success and the Board to his personal advantage and for other ulterior purposes, (2) there was no effective system of internal controls in the company, and (3) the respondents had neglected their duties as directors. The following findings against the individual non-executive directors should be highlighted, in particular their failure to:

1. make any or sufficient enquiries or request for further information about the acquisition when they knew or ought to have known of the particular circumstances;

[7] Including an increase in the market price of raw materials due to reduction and withdrawal of government subsidies to wastepaper suppliers, reduction and withdrawal of purchase rebate, increase in price of electricity and cost of steam generation

2. monitor, make enquiries or to follow up on Chook's compliance with the profit guarantee; and

3. exercise independent judgment in the consideration and investigation of the relevant issues and instead merely following orders or deferring to a single member of the Board or professional advisers.

The Court emphasised that "*a non-executive director cannot place unquestioning reliance on others to do their job*". Whilst a proper degree of delegation and division of responsibility is permissible, the extent of such delegation and division is fact-sensitive and there cannot be a total abrogation of responsibility. A Board must not permit one individual to dominate and use it to their advantage. Further, non-executive directors are expected to exercise independent judgment and supervise the decisions of executive directors.

The former vice-chairman/executive director of Long Success was found to be more culpable than the other non-executive respondents concerned in this decision. The Court considered that his breaches of duties in relation to the postponement of payment of the profit guarantee shortfall, the forfeiture of Glory Smile's right to the profit guarantee shortfall and the guarantee given by Long Success' two subsidiaries to repay the Chairman's personal debt justified a disqualification of five years.

As far as the debt guarantee is concerned, the Court appeared to have considered the fact that the former vice-chairman/executive director had been witness to the guarantee agreement of October 2011 when he had not yet assumed his position as vice-chairman/executive director. The SFC contended, and the Court found, that being witness to the guarantee agreement, he knew or ought to have known about the provision of the guarantee and the lack of objective, rational or commercial reasons for it. Whilst there would have been interesting arguments about retrospective constructive knowledge and the extended liability of a witness to a signature, the former vice-chairman/executive director did not pursue them.

Champion Technology & Kantone Holdings

On 27 April 2020, the Listing Committee censured the former executive directors of Champion Technology and its subsidiary, Kantone, and criticised the former non-executive directors of the two companies for failing to fulfil their fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with the standard established by Hong Kong law and in breach of Rule 3.08(f) of the Listing Rules[8].

Both Champion and Kantone are listed on the main board of the SEHK and engage in the sale of cultural products. Between November 2015 and 2016, Champion and Kantone acquired a large number of cultural products, the majority of which were allegedly Tianhuang stones, with a view to trade in them. These products, according to Champion Group's 2016 annual results, were worth more than HK$8.5 billion, representing approximately 92% of the then total assets of the Champion Group.

The Champion Group's auditors later engaged experts to examine the products in the preparation of financial statements and eventually issued disclaimer opinions for the financial years ended 2017 and 2018 with an impairment loss of over HK$4.22 billion in 2017,

[8] Pursuant to which director owes a duty to apply skill, care and diligence as may reasonably be expected of a person of his/her knowledge and experience and holding his/her office within an issuer.

and a further impairment loss of HK$4.27 billion in 2018, effectively writing off the acquisition.

Paul Kan (executive director of both Champion and Kantone at the time) and Leo Kan (executive director of Champion and non-executive director of Kantone at the time) were responsible for the acquisition. However, they failed to seek the Boards' prior approval for the acquisition despite the size of the investment. Further, there was no evidence showing that professional authentication and valuation of the cultural products was sought prior to the acquisition. The Listing Committee also concluded that the non-executive directors had simply relied upon Paul Kan and Leo Kan to handle the investment and had not asked for further details, such as the amount of the intended investment, how much inventory would be acquired, the risks of keeping such inventory, and how the authenticity and safety of the inventory could be ensured.

The auditors also had to record a full impairment loss of another investment made by Champion in the company's 2017 financial results in the sum of HK$418 million. The investment concerned an acquisition of interests in four private companies incorporated outside of Hong Kong (**AFS companies**) from 2000 to 2003, which were originally recorded as ready-for-sale investments. Following the departure of Paul Kan and Leo Kan from Champion's Board in 2016, Champion's management tried to communicate with the AFS companies but was unable to do so. It was eventually discovered that at least two of the AFS companies were "defunct" or "struck off and dissolved" as early as 2014. The Listing Committee found that Leo Kan had failed to monitor the investment even though he was in charge of the investment.

Conclusion

The cases of Long Success and Champion/Kantone once again remind directors of listed companies about the importance of fulfilling the duties expected of them. When considering a proposal to acquire assets of substantial value and/or other transactions which may cause a significant financial impact to a listed company (such as waiver of rights or claims), the directors should bear in mind the need to:

- conduct independent and sufficient due diligence of the target;
- seek professional valuation/advice;
- take a diligent and intelligent interest in the information presented;
- stay alert to any red flags and ask questions;
- (for non-executive directors) exercise independent judgment and supervision, rather than simply relying on the executive directors and rubber-stamping their decisions; and
- monitor the investment(s) made closely.

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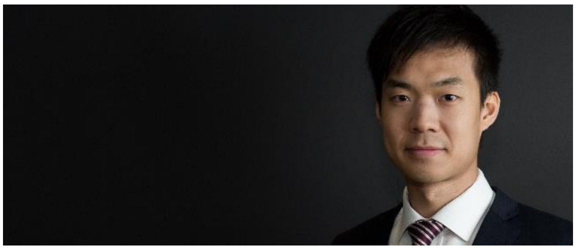

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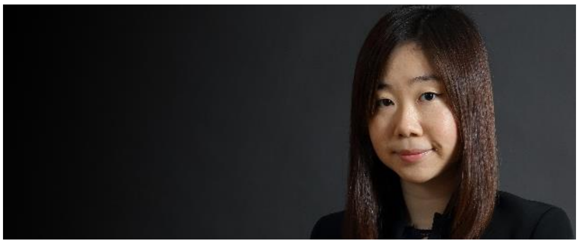

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