

## **Directors' Statutory Duty of Care: Companies Ordinance (Cap. 622)**

(Relevant to PBE Paper IV – Business Law and Taxation)

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*\* All the section numbers mentioned herein are referring to the Companies Ordinance (Cap. 622).*

### **Introduction**

It is a well established principle that directors are subject to various duties imposed by the company law. There are two main categories of duties. The first category is fiduciary duty. Fiduciary duty is a kind of relationship derived from equity in which a person (director) undertakes to act on behalf of the interests of another person (company). Fiduciary duties concern the proper exercise of power. The underlying objective is the prohibition of certain acts that may be detrimental to the interests of the person to whom the duties are owed. The second category is the duty to exercise reasonable care, skill and diligence in performing one's duties as a director. The primary concern here is that the director should demonstrate the proper level of skill. This article will discuss the duty of care.

### **Statutory Duty of Care**

The duty to exercise reasonable care, skill and diligence, or to put it simply, the duty of care, was originally based on common law<sup>1</sup> principles. The advent of the new *Companies Ordinance* (Cap. 622) altered the situation, and the duty of care of directors has now become statutory.

Under s. 465(2), a director must exercise the care, skill and diligence that would be exercised by a reasonably diligent person with:

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and
- (b) the general knowledge, skill and experience that the director has.

There are two levels of compliance. The first limb of the standard of care in s. 465(2)(a) stipulates an objective requirement. That said, it ignores the particular attributes of the director concerned, and that director is required to act to the standard exercised by a reasonably diligent person with the knowledge, skill and experience that may reasonably be expected of a director.

In contrast, s. 465(2)(b) denotes a subjective standard. It means the director will also be considered on his or her own merits. Thus, if a director has special knowledge or skills in a particular area, then the director will be required to give the company the benefit of that knowledge or skill<sup>2</sup>. An example of this would be his working experience and professional knowledge.

## **The Dual Standard**

In a nutshell, the existence of these two stipulations side-by-side means that the court will first consider the objective standard to see whether a person has acted reasonably as a director. The first criterion is a universal standard applicable to anyone who has assumed the position of director. After this consideration, the court will then also consider the director personally by referring to his or her ability on an individual and subjective basis. Every director must meet the standards on both limbs (s. 465(2)(a) & s. 465(2)(b)). However, even if a particular director has a lower than average level of skill and experience, this does not mean that he or she can act in a capacity below the objective standard. The subjective test may only raise, but not lower the standard.

## **Interpretation on the Dual Standard**

Actually, the dual standard in s. 465 is, in substance, a reflection of the common law position. The equivalent section<sup>3</sup> in the United Kingdom has been held to be a codification of the pre-existing common law position, thus the cases related to the common law duty may still be relevant to our interpretation of the statutory provision.

There are two major aspects to duty of care. Firstly, directors must take due care and exercise independent judgment on behalf of the company. Secondly, the directors shall oversee and monitor the companies' affairs and shall avoid any possible negligent omissions.

## **Exercise of Independent Judgment**

Directors shall always exercise their own independent judgment, as the law imposes a positive obligation on them. Therefore, if a director blindly follows the instructions of another person (or director) without employing his own consideration, this may amount to a breach of the director's duty of care<sup>4</sup>.

In *Law Wai Duen v Baldwin Construction Co. Ltd*<sup>5</sup>, there were four directors in the company and they were divided into two camps. It happened that the director in possession of the accounting book denied the request for inspection from the other camp. The aggrieved directors tried to seek for remedies from the court, but the defending director argued that his appointment was solely based on his expertise in construction, and thus he refused to handle the request and wanted to leave the decision to another director. The court disagreed with him, and held that no director can absolve himself from the financial affairs of the company. The defending director was found to be in breach of his duty of care by deferring his obligation to another director.

## **Monitoring Duty**

Apart from the requirement to exercise an independent judgment, a director must also duly perform his duties in monitoring the affairs of the company. This includes the

following<sup>6</sup>:

- Possessing a rudimentary understanding of the core business of the company.
- Possessing a high degree of familiarity with the company's affairs. This includes regular attendance at board meetings.
- Conducting regular reviews of the financial status of the company.

Directors are required to meet the abovementioned standards, though it is possible for them to delegate certain functions to other persons, but such delegation does not discharge them from their responsibilities entirely<sup>7</sup>.

For example, directors need to ensure that their companies comply with all the related legal and regulatory requirements. In *ASIC v MacDonald*<sup>8</sup>, a director was found to have been negligent by allowing the company to make a false and misleading statement to the market; as a result, the company was in breach of its obligation to make proper disclosure. The company was subsequently fined for this, and the court held that the negligent director should be held responsible.

## Conclusion

Prior to the advent of the new *Companies Ordinance* (Cap. 622), a director was only subject to the common law duty in exercising his skill and care. There has been a long and heated debate on the codification of directors' duties in Hong Kong. For example, in other major common law countries like the United Kingdom<sup>9</sup> and Australia<sup>10</sup>, both the directors' fiduciary duties and the duty of care have already been codified. In Hong Kong, there was a failure to achieve consensus during the consultation period, and the government finally decided to codify the duty of care of directors only. This hybrid approach was intended to balance the need for clarity and to simultaneously maintain its vibrancy with the case law development. This special arrangement may create a new spectrum on the development of the Hong Kong company law.

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<sup>1</sup> *Permanent Building Society v Wheeler* (1994) 14 ACSR 109, 155, *Base Metal Trading Ltd v Shamurin* [2005] 1 WLR 1157.

<sup>2</sup> *Re Brazilian Rubber Plantations and Estates* [1911] 1 Ch 425.

<sup>3</sup> Section 174, *UK Companies Act 2006*.

<sup>4</sup> *Law Wai Duen v Baldwin Construction Co. Ltd* [2001] 3 HKLRD 430.

<sup>5</sup> [2001] 3 HKLRD 430.

<sup>6</sup> *Daniels v Anderson* (1995) 16 ACSR 607, 664, 666.

<sup>7</sup> *Re Westmid Packing Services Ltd* [1998] 2 BCLC 646, 653.

<sup>8</sup> (2009) 256 ALR 199.

<sup>9</sup> *Companies Act 2006*, s.170-s.181.

<sup>10</sup> *Corporations Act 2001*, s.179-s.190.