

Directors' duties in Hong Kong: Codify or Not?

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Introduction

In Hong Kong, the general duties of directors are mainly found in case law, leaving aside certain specific obligations imposed by the Companies Ordinance, and by the memorandum and articles of association of a company. Director's duties can be classified into two broad categories: fiduciary duties, and duties of skill and care.

Director's duties are owed only to the company itself, but not to any individual shareholders. In *Percival v Wright* [1902] 2 Ch 421, Percival wished to sell his shares in the company and wrote to the company secretary asking if he knew of anyone willing to buy. After negotiations, the chairman of the board of directors arranged the purchase of 253 shares, 85 for himself and 84 for each of his fellow directors at a price based on Percival's valuation of the shares. The transfers were approved by the board and the transactions completed. Soon afterwards, Percival discovered that prior to and during the negotiations for the sale of his shares, another person was negotiating with the board for the purchase of the whole company and was offering various prices for shares, all of which exceeded the price paid to Percival. Percival then brought an action against the directors asking for the sale of his shares to be set aside for non-disclosure. The court held that the directors are not trustees for the individual shareholders and may purchase their shares without disclosing that they are negotiating for the sale of the entire company.

In another case, *Allen v Hyatt* (1914) 30 TLR 444, the directors of a company induced the shareholders to give them options for the purchase of their shares so that the directors could negotiate for the sale of the shares to another company. Instead of selling the shares directly to the other company, the directors used the options to purchase the shares themselves and then resold them to the other company. It was held that the directors had made themselves agents for the shareholders in the sale of the shares and must therefore account to them for the profit they had made on the sale.

In these two cases, it was illustrated that directors, generally, only owe a duty to the company itself but not to any individual shareholder of the company, regardless of whether he is a majority shareholder or minority shareholder in the company. However, if the directors have actively made themselves agents of any individual shareholder, in this exceptional circumstance, directors may owe a duty to that particular shareholder.

Fiduciary duties

The fiduciary duties of directors, which are generally based on equitable principles, mainly include:

- 1) duty to act in good faith in the interests of the company;
- 2) duty to exercise powers for proper purpose; and
- 3) duty to avoid conflicts of duty and interest.

1) Duty to act in good faith in the interests of the company

In *Re W & M Roith Ltd* [1967] 1 All ER 427, the controlling director of a company had given many years service without having a service contract. He was then given a service agreement providing for payment of a pension to his widow if he died while still a director. He was already in poor health at this time and he died two months later. The pension was paid for several years and then the company went into liquidation. The director's executors put in a claim in the liquidation for the capitalized value of the pension. The liquidator rejected the claim. It was held that the claim could not be supported. The pension was not for the benefit of the company, nor incidental to the carrying on of the company's business.

2) Duty to exercise powers for proper purpose

In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, Ampol Petroleum and Bulkships Ltd together owned 55% of the issued share capital of R W Miller (Holdings) Ltd. Ampol and Howard Smith Ltd were making competing takeover bids for Miller. The directors of Miller favoured Howard Smith's bid, which was higher, but there was no prospect of this bid succeeding because Ampol and Bulkships would not have accepted Howard Smith's offer. The evidence showed that Miller was in need of further capital. The directors of Miller resolved to allot new shares to Howard Smith for two purposes; first, to raise the capital needed, and secondly to reduce the holdings of Ampol and Bulkships to enable Howard Smith's bid to succeed. Ampol challenged the validity of the allotment. It was held that the allotment was not valid. Its dominant purpose was to alter the balance of power, and this was not the purpose for which the director's power to allot shares had been given.

3) Duty to avoid conflicts of duty and interest

In *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378, Regal owned one cinema and wanted to buy two others and sell all three together. Regal formed a subsidiary company to buy the two cinemas, but was unable to

supply all the necessary capital. All but one of the directors of Regal subscribed for shares in the subsidiary to allow the necessary capital to be raised. The cinemas were then acquired and the shares in Regal and the subsidiary sold at a profit. It was held that the directors who had subscribed for shares in the subsidiary had to account to Regal for the profit they had made, because it was only through the knowledge and opportunity they had gained as directors of Regal that they were able to obtain the shares.

Duties of skill and care

Duties of skill and care differ from more set fiduciary duties as they require directors to exercise reasonable care and skill in the performance of their functions and the exercise of their powers. These duties are derived from the common law principles of negligence.

These existing duties are typically portrayed as relatively lenient, especially when matched against the more onerous and rigorously enforced matrix of fiduciary duties owed by company directors. A traditional laxity of application and a benevolent, sometimes almost indulgent judicial attitude has done nothing to contradict this image.

In *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, the chairman of the company committed fraud by purporting to buy Treasury Bonds just before the end of the accounting period and selling them just after the audit. By this method a debt due to the company from a firm in which the chairman had an interest was reduced on the balance sheet by increasing the assets. The liquidator of the company attempted to make the other directors liable for failing to discover the fraud. (They had left the management of the company entirely in the hands of the chairman). The liquidator failed.

In this case, Romer J formulated three propositions by which to measure a company director's skill and care; in so doing, he established the superstructure of the modern law in this sphere:

- i) A director needs not, in performance of his duties, exhibit a greater degree of skill than may reasonably be expected of a person of his knowledge and experience.
- ii) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever in the circumstances he is reasonably able to do so.
- iii) In respect of all duties that may properly be left to some other official, having regard to the exigencies of the business and the articles of the company, a director, in the absence of grounds for suspicion, is justified in trusting that official to perform such duties honestly.

In summary, the City Equitable standard of competence requires a director to exercise the degree of skill and diligence that might reasonably be expected of a person of his particular knowledge and experience when organizing his own affairs in the context of the particular circumstances of a case. The level of care to be expected of a company director is ‘the care that an ordinary man might be expected to take in the circumstances on his own behalf.’ The frailties, both of the test and the policy it articulates, are manifest. Clearly there is no difficulty where the director under scrutiny possesses a high level of personal skill and relevant professional qualifications: such an individual can be judged quite fairly and appropriately by his own exacting standards. Unfortunately, it follows that less talented and unqualified individuals will be measured against a generally unsatisfactory benchmark that is determined by their own limited capacity. In other words, if an idiot is appointed to serve as a director, the law will expect nothing more from him in the discharge of his duties than the standard of care, behaviour and performance of a reasonable idiot.

Reforms in Hong Kong

Some common law countries, such as the UK, Australia, and Singapore, have codified some of the fiduciary duties and duties of skill and care in their statute law. The main reason for this move is that the case law on directors’ duties is quite complex and often inaccessible to the public. However, at present, Hong Kong has still not codified any directors’ duties into our Companies Ordinance, though the Registrar of Companies has issued several Non-statutory Guidelines on Directors’ Duties in Hong Kong. It was argued that codification can improve clarity and certainty for company management and members. On the other hand, there are some arguments against codifying directors’ duties. For example, fiduciary duties cannot be codified without being stated in detailed terms in which case there will be a loss of flexibility. It was also argued that if codification co-exists with common law and its development through judicial interpretation, this may lead to greater uncertainty and would not resolve the question of accessibility.

In the UK, the Companies Act 2006 introduces a statutory statement on directors’ duties which covers the following general duties:

- 1) duty to act within powers;
- 2) duty to promote the success of the company;
- 3) duty to exercise independent judgment;
- 4) duty to exercise reasonable care, skill and diligence;
- 5) duty to avoid conflicts of interest;
- 6) duty not to accept benefits from third parties; and
- 7) duty to declare interest to proposed transaction or arrangement.

However, it is a little bit strange that the remedies for breach of the above general duties have not been codified in the Companies Act 2006. Section 178 of the Act provides that the same consequences and remedies as are currently available should apply to breach of the statutory general duties. Hong Kong is now in the process of re-writing our Companies Ordinance and the question of whether or not to codify our directors’ duties has become one of the most important issues under debate. **T/D**