

CHAPTER 3

DIRECTORS' DUTIES

Background

- 3.1 We are considering whether directors' general duties should be codified in Hong Kong.
- 3.2 At present, the general duties of directors in Hong Kong are mainly found in case law²⁰. They can be classified into two broad categories, namely fiduciary duties²¹ and duties of care and skill²². Some common law jurisdictions such as the UK, Australia and Singapore have codified some of the fiduciary duties and the duties of care and skill in statute law. The main reason is that the case law on the topic is complex and often inaccessible to the public. Codification can improve clarity and certainty for company management and members.
- 3.3 There are, however, 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. 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.
- 3.4 The issue concerning whether to codify directors' duties in the statute first emerged in the Second Report of the Companies Law Revision Committee in 1973²³ and there were attempts for statutory statements in the Companies (Amendment) Bill 1980 and the Companies (Amendment) Bill 1991²⁴ respectively. The proposed legislative amendments, however, have not been enacted into law. The subject was last considered by the SCCLR in its CGR from 2001 to 2003. Noting that

²⁰ Other sources of directors' duties can be found in the company's memorandum and articles of association, directors' contracts with the company, specific provisions under the statutes (e.g. the CO) or the Listing Rules.

²¹ Fiduciary duties that apply to directors include: (i) duty to act in good faith in the interests of the company, (ii) duty to exercise powers for proper purpose, (iii) duty to refrain from fettering his own discretion, (iv) duty to avoid conflicts of duty and interest, and (v) duty not to compete with the company. They are based on the equitable principles.

²² Duties of care and skill require directors to exercise reasonable care and skill in the performance of the functions and the exercise of the powers of the directors. The duties are derived from the common law principles of negligence.

²³ It set out the recommendation of the UK Jenkins Committee in its Report of 1962 of a statutory statement.

²⁴ The respective wording in the Companies (Amendment) Bill 1980 and the Companies (Amendment) Bill 1991, reflected the recommendation of the UK Jenkins Committee in its Report 1962, was without prejudice to the common law and equitable principles.

the views of the respondents to the consultation exercise on the issue were equally balanced as to whether a statutory statement should be introduced, the SCCLR recommended the publication of non-statutory guidelines, stating the principles of law in Hong Kong in relation to directors' duties, to promote the awareness of directors of their duties²⁵. The SCCLR also suggested that the issue should be revisited after more experience is gained on the practical application of the statutory approach in those jurisdictions where such an approach has been adopted such as the UK.

- 3.5 Pursuant to the SCCLR's recommendation, the Non-statutory Guidelines on Directors' Duties in Hong Kong²⁶ were first issued by the CR in January 2004. The latest Guidelines issued in October 2007 are at **Appendix II**.

Recent Developments in the United Kingdom

- 3.6 In the UK, the CA 2006 introduces a statutory statement on directors' duties which covers the following general duties²⁷:

- (a) duty to act within powers;
- (b) duty to promote the success of the company;
- (c) duty to exercise independent judgment;
- (d) duty to exercise reasonable care, skill and diligence;
- (e) duty to avoid conflicts of interest;
- (f) duty not to accept benefits from third parties; and
- (g) duty to declare interest to proposed transaction or arrangement.

The relevant sections are extracted at **Appendix III**.

- 3.7 While the statutory duties replace the corresponding common law rules and equitable principles from which they derive, these duties are required to be

²⁵ In July 2001 and June 2003, the SCCLR published two consultation papers on proposals made in Phases I and II of the CGR respectively. The question of a statutory statement of directors' duties was put out for public consultation. In January 2004, the SCCLR issued its final recommendations. See paragraphs 7.01-7.12 at pages 15-20 of the SCCLR's *Corporate Governance Review - A Consultation Paper on Proposals Made in Phase II of the Corporate Governance Review* (June 2003) and *Corporate Governance Review - Final Recommendations*, available at <http://www.cr.gov.hk>.

²⁶ Copies of the Non-statutory Guidelines on Directors' Duties in Hong Kong were widely distributed at the offices and the websites of the relevant Government offices and public agencies such as the CR, the SFC, Hong Kong Exchanges and Clearing Limited, the Official Receiver's Office and the Hong Kong Monetary Authority. Directors are required to sign an acknowledgment that they have obtained a copy of and read the Guidelines when submitting a company's annual return.

²⁷ The CA 2006 is implemented by stages. Sections 170-181 (scope and nature of general duties, the general duties and supplementary provisions) commenced operation on 1 October 2007 except for sections 175-177 (duty to avoid conflicts of interest, duty not to accept benefits from third parties, duty to declare interest), 180(1), (2) (in part) and (4)(b) (approval or authorisation by members) and 181(2) and (3) (charitable companies) which will commence operation on 1 October 2008.

interpreted in the same way as common law rules and equitable principles. In other words, the courts should interpret and develop the general duties in a way that reflects the nature of the rules and principles they replace²⁸. This approach displays the UK Government's intention to achieve both the precision of the statutory statement and the continued flexibility and development of the law. However, the effectiveness of this intention is subject to trial after the statutory statement has been implemented²⁹.

- 3.8 The statutory duties do not cover all the duties that a director may owe to the company. Many duties are imposed elsewhere in the legislation, such as the duty to file accounts and returns to the Registrar of Companies. Other duties remain uncodified, such as the duty to consider the interests of creditors in times of threatened insolvency.
- 3.9 The remedies for breach of the statutory general duties have not been codified in the CA 2006. The CA 2006 states that the same consequences and remedies as are currently available should apply to breach of the statutory general duties³⁰. Where the statutory duties depart from their equitable equivalent, the court must identify the equivalent rule and apply the same consequences and remedies.
- 3.10 The UK goes beyond simply codifying the existing common law rules and equitable principles on directors' duties. It also attempts to modernise the law by introducing the principle of "enlightened shareholder value"³¹ under the duty to promote the success of the company. The duty requires a director to act in the way which he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and, in doing so, having regard to a list of wider factors, such as the interests of employees, suppliers and customers and the impact of the company's operation on the environment³². The

²⁸ See sections 170(3) and (4) of the CA 2006 at Appendix III and paragraph 305 of the official Explanatory Notes to the CA 2006 at http://www.opsi.gov.uk/acts/acts2006/en/ukpgaen_20060046_en.pdf.

²⁹ See comments in House of Commons Third Reading, Col. 1104 (19 October 2006) and also paragraph 3.11 below.

³⁰ See section 178 of the CA 2006 at Appendix III.

³¹ The concept of "enlightened shareholder value" is that, while the directors must promote the success of the company for the benefit of shareholders, this can only be achieved by taking due account of wider business factors (such as the interests of employees, suppliers and customers and the impact of the company's operation on the environment) rather than simply focusing on immediate or short term shareholder gratification. Some proponents pointed out that this is a new formulation with no grounding in common law, in contrast to the traditional and well understood principle of a director having a duty to act "bona fide in what they consider...is in the interests of the company" and the elements as listed in section 172 of the CA 2006 were considered desirable in the review of the CLRSO.

³² See section 172 of the CA 2006 at Appendix III. The UK Government considers that the traditional formulation of a director's duty to act in the interests of the company is not clear. As a company is an artificial legal entity, it is hard to understand what the "interests of the company" are. The UK Government believes that new formulation in section 172 of CA 2006 resolves any confusion as to what the interests of the

list is not exhaustive, but highlights areas of particular importance which reflect wider expectation of responsible business behaviour. The duty does not require a director to do more than good faith and reasonable care, skill and diligence³³.

- 3.11 There were heated debates in the UK during the process of introducing the statutory statement of directors' duties. While some commentators praised the statement for improving clarity and certainty and striking a good balance between precision and flexibility, others were concerned that the statement created new uncertainties and difficulties. For example, the requirement for directors to take into account various new factors in complying with the duty to promote the success of the company may pose new challenges to directors³⁴. A summary of the arguments for and against the codification of directors' duties in the UK is at **Appendix IV** for reference. Some of the provisions in the statutory statement have only come into force on 1 October 2007 while the others will commence operation later this year. Until there is case law in relation to the new duties, directors are left with uncertainty as to how the courts will interpret the new statutory statement.

Australia and Singapore

- 3.12 Some other common law jurisdictions like Australia and Singapore have also adopted statutory statements of directors' general duties. In Australia, statutory duties of directors have been introduced since 1991 and are mainly contained in sections 180 to 183 of the ACA³⁵. In addition to common law relief, additional consequences, such as civil penalties, disqualification orders and criminal convictions, may stem from breaches of the statutory directors' duties³⁶. In Singapore, the statutory

company are. It is also a common-sense approach that reflects the modern view of the way in which businesses operate in their community. See *Companies Act 2006: Duties of company directors, Ministerial Statements* (June 2007) at <http://www.berr.gov.uk/files/file40139.pdf>. On the other hand, some commentators have queried that the new formulation will cause serious complications for directors. There are also concerns over the addition of the elements to which the directors must have regard to and whether that would lead to prospect of litigation.

³³ See paragraphs 327 and 328 of the official Explanatory Notes to the CA 2006 (see footnote 28 above).

³⁴ See, for example, Briefing for Clause 158 of the Company Reform Bill printed on 24 May 2006 in the Parliamentary Brief (13 June 2006) by the Law Society of the UK.

³⁵ Section 180 imposes a duty to use care and diligence of a reasonable person in like circumstances and provides for the operation of the business judgment rule. Section 181 requires the exercise of powers and discharge of duties in good faith and in the best interests of the corporation and for a proper purpose. Sections 182 and 183 prohibit improper use of position and information to gain an advantage for the directors themselves or for any other person or to cause detriment to the corporation.

³⁶ Under section 180(1) of the ACA, the court may order the payment of a pecuniary penalty of up to A\$200,000. This is not a compensatory order. The purpose is to punish the director and to provide a general deterrence effect. See Julie Cassidy, *Directors' Duty of Care in Australia – a Reform Model* (June

statement of directors' duties is set out in section 157 of the SCA³⁷. The Australian and Singaporean approaches differ from the UK's in that the statutory duties in the ACA and the SCA have effect in addition to the existing common law and equitable principles and therefore the common law rules and codifying statute can be used together to develop the law³⁸.

Considerations

3.13 The issue concerning codification of directors' duties has recently been revisited by the SCCLR. Having considered the recent developments in the UK, the SCCLR suggested that the issue of codification of directors' duties should be brought up for public consultation. While the SCCLR saw some advantages in codifying directors' duties along the UK model to make the law clearer and more accessible to the public, it also noted that the UK approach on directors' duty to promote the success of the company might cause some concerns among the business community. The Government would therefore like to hear the views of the public before taking a final view on the issue.

Question 4

- (a) Do you agree that the general duties of directors should be codified in the Companies Bill?**
- (b) If your answer to Question (a) is in the affirmative, do you agree that the UK approach, including the duty to promote the success of the company for the benefit of its members as a whole having regard to such factors like the long-term consequences of a decision, the interests of employees, the impact of the company's operations on the community and the environment, etc., should be adopted? OR**
- (c) If your answer to Question (a) is in the negative, do you have any views on how the directors' duties could be clarified or made more accessible?**

2007), unpublished paper, pages 13-14.

³⁷ Section 157 of the SCA provide for a director's duties as follows:

“(1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.

(2) An officer or agent of a company shall not make improper use of any information acquired by virtue of his position as an officer or agent of the company to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the company.”

³⁸ See section 185 of the ACA and section 157(4) of the SCA.