

PART 10

DIRECTORS AND SECRETARIES

Introduction

1. Part 10 deals with directors and secretaries of a company. It mainly reorganises, with some modifications, the existing provisions of the CO relating to the appointment, removal and resignation of directors and secretaries, and directors' liabilities. The Part also introduces a new statutory statement on directors' duty of care, skill and diligence. Some miscellaneous provisions concerning directors and secretaries under sections 119, 153B, 153C, 154B and 156 of the CO are restated in **Division 5** (Miscellaneous provisions relating to directors and secretaries). These include provisions on directors' vicarious liability for the acts of their alternates, the avoidance of acts done by a person in a dual capacity as director and secretary, prohibition of undischarged bankrupts from acting as director, recording of minutes of directors' meetings, the status of such minutes as evidence of proceedings at the meetings and provision of written records of decisions of sole directors of private companies. Provisions concerning fair dealing by directors are covered in Part 11.

- The significant changes to be introduced under this Part are highlighted below:
 - (a) **Restricting corporate directorship in private companies;**
 - (b) **Enabling the Registrar to give directions to a company relating to the appointment of directors and secretaries;**
 - (c) **Codifying directors' duty of care, skill and diligence;**
 - (d) **Setting out rules on indemnification of directors against liabilities to third parties; and**
 - (e) **Requiring ratification of conduct of directors by disinterested shareholders' approval.**

Significant Changes

(a) Restricting corporate directorship in private companies

Background

2. Since 1985, all public companies and private companies which are members of a group of companies of which a listed company is a member have been prohibited from appointing a body corporate as their director, whereas other private companies can continue to have corporate directors.
3. In April 2008, we consulted the public on whether corporate directorship should be abolished altogether in Hong Kong, subject to a reasonable grace period, or should be restricted by requiring every company to have at least one natural person as its director, as in the UK. The respondents' views were diverse.¹ In view of the equally strong opinions on the need to enhance corporate governance and transparency and the legitimate commercial need for flexibility, the UK approach appears to strike an appropriate balance between the two. We therefore recommend its adoption.

Proposal

4. **Clause 10.5** implements the proposal to restrict corporate directorship in private companies by requiring a private company (other than one within the same group of a listed company) to have at least one director who is a natural person. The existing provision in section 154A of the CO prohibiting a public company and a private company within the same group of a listed company from appointing a body corporate as their director is restated in **Clause 10.4**.

¹ See FSTB, *Consultation Conclusions on Company Names, Directors' Duties, Corporate Directorship and Registration of Charges* (December 2008), paragraphs 26 to 29 (available at http://www.fstb.gov.hk/fsb/co_rewrite).

(b) **Enabling the Registrar to give directions to a company relating to the appointment of directors and secretaries**

Background

5. At present, the CO requires a private company to have at least one director and a public company at least two directors.² In default, the company and every officer in default are liable to a fine. In addition, every company should appoint a secretary though there is no offence provision for failure to appoint one.³
6. We consider provisions empowering the Registrar to give direction to the company requiring it to appoint a director or secretary useful for better enforcement of the requirement relating to the appointment of directors and secretaries. There are similar provisions in the UK and Singapore.⁴

Proposal

7. **Clause 10.6** introduces a new provision to enable the Registrar to give directions to a company requiring it to appoint a director or directors in compliance with the statutory requirements. Non-compliance with the direction is an offence. The company and every responsible person will be liable to a fine.
8. Currently, failure to comply with the appointment requirement would immediately lead to an offence. With the introduction of **Clause 10.6**, there seems to be no need to retain the offence provisions relating to the appointment of directors in sections 153(3) to (4) and 153A(3) to (5) of the CO.
9. **Clause 10.26** introduces a similar provision to enable the Registrar to give directions to a company requiring it to appoint a secretary in compliance with the statutory requirements. Non-compliance with the direction will be an offence. The company and every responsible person will be liable to a fine.

² Sections 153 and 153A of the CO.

³ Section 154 of the CO.

⁴ Sections 156 and 272 of the UKCA 2006 and Section 145(7) of the SCA.

(c) Codifying directors' duty of care, skill and diligence

Background

10. At present, the general duties of directors in Hong Kong are mainly found in case law.⁵ They can be classified into two broad categories, namely fiduciary duties⁶ and duty of care, skill and diligence.⁷
11. The issue of whether directors' general duties should be codified was raised for public consultation during April to June 2008. Responses were highly divided. We concluded that it would be premature to go down the route of comprehensive codification at this stage.⁸
12. Nevertheless, we see some merit in clarifying the directors' standard of care, skill and diligence as proposed by some respondents. The standard in the old case law focusing on the knowledge and experience which a particular director possesses is too lenient nowadays. Other comparable jurisdictions such as the UK have developed a so-called "mixed objective/subjective test" with a minimum objective standard of care expected of all directors and a subjective test looking at the personal attributes of a particular director that can raise the standard expected of the director above the minimum objective standard. In the absence of a clear case authority in Hong Kong in this respect, there is some uncertainty as to how far the test will be applied by the Hong Kong court under the common law. We therefore recommend introducing a statutory statement on the duty of care, skill and diligence along the lines of section 174 of the UKCA 2006 to clarify the law and provide appropriate guidance to directors.

⁵ 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.

⁶ 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. Such fiduciary duties arise in equity.

⁷ Duty of care, skill and diligence requires directors to exercise reasonable care, skill and diligence in the performance of the functions and the exercise of the powers of the directors. The duty arises both in equity and from the common law principles of negligence.

⁸ See FSTB, Consultation Conclusions on *Company Names, Directors' Duties, Corporate Directorship and Registration of Charges* (December 2008), paragraphs 17 to 20 (available at http://www.fstb.gov.hk/fsb/co_rewrite).

Proposal

13. **Clause 10.13(1) and (2)** defines the standard of care, skill and diligence as the standard 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.
14. Paragraph (a) provides an objective test whereas paragraph (b) a subjective test. The objective test is the minimum standard. It can be adjusted upwards to reflect any special skill, knowledge and experience possessed by a particular director but cannot be adjusted downwards to accommodate someone who is incapable of attaining the basic standard of what can reasonably be expected of the reasonably diligent person carrying out the same function.
15. **Clause 10.13(4)** provides that the statutory duty has effect in place of the corresponding common law rules and equitable principles as the retention of the latter may result in differing standards and hinder the development of the statutory provision.
16. **Clause 10.13(5)** provides that **Clause 10.13** (directors' duty to exercise reasonable care, skill and diligence) applies to a shadow director as it applies to a director. "Shadow director" is defined in **Clause 1.2(1)** to mean, in relation to a body corporate, a person in accordance with whose directions or instructions (excluding advice given in a professional capacity) the directors, or a majority of the directors, of the body corporate are accustomed to act.
17. The corresponding section in the UK is section 170(5) of the UKCA 2006 which provides that the statutory general duties of directors (which comprise both fiduciary duties and duty of care, skill and diligence) apply to shadow directors where, and to the extent that, the common law rules or equitable principles which they replace so apply. The subsection was enacted against the background of the decision in the case of *Ultraframe* which indicated that directors' fiduciary duties might not also apply to

shadow directors⁹. It was so drafted to allow the law to develop as the UK government was of the view that the law was unclear on the subject and it was right to leave this undeveloped area of law to the courts.¹⁰

18. Section 170(5) of the UKCA 2006 is not adopted in **Clause 10.13(5)** as we consider that the case of *Ultraframe* and the UK government's concern are basically on directors' fiduciary duties instead of on the duty of care, skill and diligence and therefore, it is not necessary to adopt the complicated concept under section 170(5) of the UKCA 2006.
19. Directors have powers to manage a company's business and exercise the company's power and thereby owe a duty of care, skill and diligence to the company in the performance of the functions and the exercise of the powers of directors. There is little common law authority on the application of directors' duty of care, skill and diligence to shadow directors. We consider that it is the right approach to subject shadow directors to the same statutory duty of care, skill and diligence as a duly appointed director, because anyone who interferes in the affairs of a company to the extent that makes him fall within the definition of a shadow director must take on the same responsibilities and duties as those of a director. This indeed tally with the other provisions relating to directors in the Companies Bill which extend to shadow directors the same prohibitions and obligations imposed on directors (see, for example, clauses 11.7, 11.32, 11.46, 11.54, 11.66, 11.68 and 11.69).
20. **Clause 10.14** preserves the existing civil consequences of breach (or threatened breach) of the statutory duty. The remedies for breach of the statutory duty will be exactly the same as those that are currently available following a breach of the common law rules and equitable principles that the statutory duty replaces.

⁹ *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638(Ch) at [1284] and [1286]: the mere fact that a person falls within the statutory definition of shadow director is not enough to impose on him the same fiduciary duties to a company as are owed by a *de jure* or *de facto* director and the facts must go further and suggest that there is a fiduciary relationship.

¹⁰ Hansard (House of Commons cols 525 to 526, 6 July 2006).

(d) Setting out the rules on indemnification of directors against liabilities to third parties

Background

21. A director may incur liabilities to third parties in the course of performing his duties. The law regulating his right to be indemnified against such liabilities is not found in the CO but in case law,¹¹ which is fairly difficult for lay directors to understand. Practitioners have raised concerns over the absence of statutory provisions confirming the ability of companies to provide indemnities for liabilities incurred by directors to others in the course of performing their duties.
22. The uncertainty over the right to be indemnified against liabilities to third parties may deter competent persons from accepting directorships and is therefore undesirable. We note that the UK has reformed the law on directors' liability in recent years. In view of the recent increase in legal actions against directors personally and the costs of lengthy court proceedings, the UK has permitted indemnification of directors against most of the liabilities to third parties, so as to maintain a diverse pool of qualified individuals willing to assume directorship and a willingness of directors to take informed and rational risks.¹² To enhance transparency, any such permitted indemnity provision should be disclosed in a directors' report and made available for inspection by shareholders. The UK has also removed the prohibition on a company to exempt a non-director officer (i.e. a manager or company secretary) from, or to indemnify him against, any liability for the reason that it is ultimately a matter for the board to determine the conditions of employment of senior employees. We see merit in following the UK approach in setting out and clarifying the rules. Some technical amendments are also proposed to improve the existing provisions in section 165 of the CO.

¹¹ Section 165 declares void any provision in a company's articles or in any contract with the company or otherwise, exempting a director or any other officer from, or indemnifying him against, any liability to the company or a related company in respect of any negligence, default, breach of duty or breach of trust in relation to the company or a related company. Indemnification of directors' liability to third parties is not prohibited but subject to the common law rules.

¹² See UK Department of Trade and Industry, *White Paper on Company Law Reform* (March 2005), page 23.

Proposal

23. **Clause 10.16** extends the current prohibition under section 165(1) of the CO to include any indemnity provided by a related company.¹³ This is intended to close a loophole under that sub-section which does not prohibit a company from providing an indemnity for a director of a related company. Consequential to the change in **Clause 10.16**, **Clause 10.17** extends the scope of liability insurance allowed to cover the directors of a related company.
24. **Clause 10.18** defines the scope of permitted indemnities against liability incurred by a director to third parties. It provides that any indemnity must not cover the following:
- (a) criminal fines or penalties imposed in respect of non-compliance with any requirement of a regulatory nature;
 - (b) liability incurred in defending criminal proceedings in which the director is convicted;
 - (c) liability incurred in defending civil proceedings brought by the company or a related company in which judgment is given against the director; and
 - (d) liability incurred in connection with an application for relief in which the Court of First Instance refuses to grant the director relief.
25. **Clause 10.19** adds a new provision to require a company which provides any permitted indemnity to its directors to disclose it in the directors' report. **Clauses 10.20** and **10.21** further require the company to make the permitted indemnity provision available for inspection by its shareholders and to provide a copy to any shareholder on request and upon the payment of a fee to be prescribed in subsidiary legislation.

¹³ The term "related company" under section 165 of the CO has been changed to "associated company" in the CB. The definition is essentially the same.

(e) **Requiring ratification of conduct of directors by disinterested shareholders' approval**

Background

26. At present, the ratification of acts or omissions of directors is subject to the common law rules, which generally require shareholders' approval to release the directors from their fiduciary duties in a general meeting. Ratification would have the effect of barring the company from bringing actions against the director for damages it suffered as a result of the ratified act or omission, albeit it might not prevent dissenting minorities from pursuing unfair prejudice claims or statutory derivative claims.
27. The UK has introduced a significant change to its law on the ratification of conduct of directors by adding a disinterested shareholders' approval requirement.¹⁴ The new requirement aims to prevent conflicts of interests, in particular, possible manoeuvring of the rule by majority shareholders to ratify any unauthorised conduct of directors appointed by them. We recommend following the UK approach in this respect.

Proposal

28. **Clause 10.22** provides that any ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company must be approved by resolution of the members of the company disregarding votes in favour of the resolution by the director, any entity connected with him and any person holding shares of the company in trust for him or for the connected entity. This preserves the current law on ratification with an additional requirement of disinterested shareholders' approval.

¹⁴ See section 239 of the UKCA 2006. Any decision by a company to ratify conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company must be taken by the members (but not the directors), and without reliance on the votes in favour of the resolution by the director (if he is also a member of the company) or any member connected with him.

Other Changes

(a) Minimum age requirement for appointment as director

29. **Clause 10.7** generally restates the existing minimum age requirement for appointment as director under section 157C of the CO, i.e. the age of 18 years or above. In addition, two new provisions are added:

- (a) Sub-clause (2) – to provide for the consequence of contravention of the requirement; and
- (b) Sub-clause (3) – to clarify that the minimum age requirement does not exempt an underage director from criminal prosecution or civil liability if he or she purports to act as director, or acts as a shadow director, although he or she could not, by virtue of the section, be validly appointed as a director .

Clause 10.7(3) aims to deter any company from appointing underage directors in order to exploit their immunity from prosecution or the reluctance of enforcement authorities to pursue young persons.

(b) Validity of acts of directors

30. **Clause 10.9** restates with modifications part of section 157 of the CO to provide that the acts of a director shall be valid notwithstanding any defect that may afterwards be discovered relating to his appointment or qualification etc. It does not, however, restate the similar provision regarding the validity of the acts of a manager. We are of the view that, as there is no provision in the CO governing the appointment and qualifications of a manager, the validity of the acts of managers should best be left to be dealt with by the common law rules.