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CLYDE & CO

**Directors, Officers and Managers Liability
In Hong Kong**

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Directors, Officers and Managers Personal Liability The Legal Position in Hong Kong

1 Structure of Hong Kong's Corporate Entities

Corporate entities in Hong Kong are usually in the form of limited liability companies. Companies are incorporated under the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) and, once incorporated, will acquire a separate legal identity and hence a separate liability (which is usually limited) distinguishable from the people forming them. Companies are nevertheless artificial legal entities and must therefore act through some organs or agents on their behalf. The organs or agents are usually called "the board of directors". As will be discussed below, in running the companies, directors may incur personal liability which may be unlimited.

2 Who are Directors, Officers and Managers?

A "Director", as in the United Kingdom legislation, includes any person occupying the position of director, by whatever name called, (s2 Companies Ordinance) and this means that another officer of the company, attending and voting at board meetings could constructively be a director of the company.

"Officer" in relation to a body corporate includes a director, manager or secretary (s2, Companies Ordinance). This, too, is a non-exhaustive definition and may include other employees of the company. S154 of the Companies Ordinance provides that every company shall have a secretary and is therefore a mandatory requirement.

At the moment, there is no definition for the term "manager" in the Companies Ordinance. On 18 January 2002, the Hong Kong Government published the Companies (Amendment) Bill 2002 in which it was proposed that a definition for "manager" be added as follows:-

"manager" in relation to a company, means a person occupying a position under the immediate authority of the board of directors but does not include:-

- (a) a receiver or manager of the property of the company; or
- (b) a special manager of the estate or business of the company appointed under section 216."

[Note: section 216 of the Companies Ordinance relates to the appointment of a special manager for a company in liquidation].

3 Legal Bases of Directors, Officers and Managers Liability in Hong Kong

Directors and Officers can incur liability in Hong Kong under both locally enacted Ordinances and Common Law principles established by Hong Kong and English precedents.

3.1 Hong Kong Ordinances

Hong Kong's own legislation imposes a variety of liabilities upon the directors and officers of Hong Kong companies. In some areas, the provisions of the Hong Kong Ordinances are in similar terms to the Acts of the UK parliament, but there are crucial differences. As will be seen later, one difference makes directors and officers liability insurance far more problematic in Hong Kong than it now is in the United Kingdom.

(a) Civil liability of directors

Two examples arising under the Companies Ordinance are:-

(1) **Untrue statements in a Company Prospectus**

Under s40(1)(a) of the Companies Ordinance, a company director shall be liable to pay compensation to all persons who subscribe for any shares or debentures on the faith of the prospectus where the persons concerned have sustained loss or damage by reason of any untrue statement contained in the prospectus.

(2) **Personal Liability on Company Cheques**

Under s93(5) of the Companies Ordinance, if a cheque does not bear the company name, a director signing the cheque commits an offence and is personally liable on it. Under s26 of the Bills of Exchange Ordinance, a director signing a company cheque is personally liable on the cheque unless he adds words indicating that he signs the instrument for and on behalf of a principal or in a representative capacity.

Besides imposing civil liability on directors personally, Hong Kong Ordinances also impose criminal liability on directors.

(b) Criminal liability of directors

(1) General Liability

Under s 101E of the Criminal Procedure Ordinance, if it is proved that any offence under any Ordinance committed by a company has been committed with the consent or connivance of a director or any other officer concerned in the management of the company, or any person purporting to act as such director or officer, the director or other officer shall be guilty of the like offence.

(2) Examples of Specific Liability

(i) Under sections 31 and 63A of the Employment Ordinance, an “employer” (which includes the duly authorised agent of an employing company, s2) commits an offence and is therefore personally liable to a fine if he employs a person or fails to terminate the employment of a person at a time when he does not believe on reasonable grounds that all wages can be paid as they fall due. This liability cannot be modified by a service contract between an officer and the company because of s165 of the Companies Ordinance which is discussed in greater detail in paragraph 8 below.

(ii) Section 16 of the Dangerous Goods Ordinance stipulates that any offences committed by a company under the Ordinance will expose every director and officer concerned in the management of the company to a criminal penalty, unless he can prove that the act constituting the offence took place without his knowledge or consent.

The Companies Ordinance and many other Hong Kong Ordinances (e.g. the Securities and Futures Commission Ordinance and the Protection of Investors Ordinance) contain further examples of criminal liability which can be incurred by the directors and officers of a company, and which are punishable by fines and/or imprisonment.

(c) Other relevant non-statutory obligations

Examples are the Listing Rules of the Hong Kong Stock Exchange, the Hong Kong Stock Exchange's Guide for Directors of Listed Companies (including the Code of Best Practice) and the Model Code for Securities Transactions by Directors of Listed Companies.

3.2 Common Law

At Common Law, directors owe general fiduciary duties and duties of skill and care to the company. If they breach these duties, they may be liable to the company, and in certain circumstances, the company's members, liquidators or creditors.

In some other circumstances, the Common Law will also impose an independent duty of care, owed to third parties, upon the directors and officers of a company personally.

Specific Liabilities of Directors and Officers

As indicated above, directors and officers are exposed to personal liability because of their position. Examples are:-

(1) Breach of Fiduciary Duty

The "fiduciary duty" of directors means that they must act honestly and with the utmost good faith in the discharge of their duties. Their power as directors must be exercised for the benefit of the company, and they must retain complete freedom of action in the performance of their duties.

One example of a breach of this fiduciary duty is when a director by reason of his or her position in the company has acquired confidential price-sensitive information relating to the shares of the company, and deals in that company's shares with a view to gaining profit or avoiding loss.

(2) Duty of Skill and Care

In addition to these fiduciary duties, the directors of a company are expected to exercise due skill and care in the performance of their duties. They must exhibit a reasonable amount of competence and must not act negligently in the management of the company's affairs.

3.3 Specific areas of concern

(a) Relief from liability

S358 of the Companies Ordinance empowers a Court to relieve the officers of the company from any liability for negligence, default, breach of duty or breach of trust where the Court concludes that, in all the circumstances of the case, it would be fair for such a person to be excused where the officer has acted honestly and reasonably. The power of the Court to grant relief under s358 applies to proceedings brought by or on behalf of the company against its directors and to proceedings for the enforcement of the Companies Ordinance.

In practice orders under s358 are rarely made by the Courts.

(b) Unlimited liability of directors

S159 of the Companies Ordinance provides that if the memorandum of a limited company so provides, the liability of the directors or managers of such a company may be unlimited. When a person is proposed for such an appointment as director or manager of a company, the proposal must include a statement to the effect that the liability of the director or manager is unlimited. Before a person accepts such a position he or she must be given notice in writing of the fact that their liability will be unlimited. Failure to include such a statement or to provide such notice may lead to the imposition of a fine upon the director, manager or proposer who made default. The failure to satisfy these requirements may also lead to the imposition of a liability to pay damages for any loss sustained by the person who was appointed to the position having such unlimited liability.

S160 of the Companies Ordinance provides that a limited liability company may amend its memorandum of association by passing a special resolution to make the liability of its directors, managers or managing directors unlimited.

In practice, such clauses are rarely seen.

4 Statutes of Limitation

4.1 Civil Actions

The Limitation Ordinance lays down certain limitation periods in relation to civil claims. Generally speaking :-

- The 3 year time limit applies in actions for negligence, breach of duty where the damages claimed by the plaintiff include damages for personal injuries or actions under the Fatal Accidents Ordinance.
- The 6-year time limit applies to actions founded on tort (e.g. fraud) or contract, actions to recover any sums recoverable by virtue of any ordinance (e.g. recovery of tax by the Inland Revenue Department) or actions for account.

There is no limitation period applicable to an action by a beneficiary against a trustee in respect of the trustee's fraud or fraudulent breach of trust or the recovery of trust property in the possession of the trustee or converted by him.

4.2 Criminal Prosecution

The most significant categories of offences in Hong Kong are indictable offences and summary offences. Indictable offences are serious offences (e.g. fraud or tax evasion), which are usually tried before a judge and jury. Summary offences are relatively minor offences, which are usually tried before a magistrate.

No time limits exist for initiating prosecution in criminal matters at common law. However, the Magistrates Ordinance provides that for any offence other than an indictable offence, prosecution must commence within six months from the time of the commission of the offence, unless another ordinance prescribes a longer time limit (which is quite common).

4.3 Specific Legislation

The following are examples of ordinances that lay down specific time limits for commencing legal proceedings:-

- Under the Sex Discrimination Ordinance, a civil claim for discrimination or sexual harassment shall not be considered by the Courts unless proceedings are commenced within 24 months

of the act complained of unless the Court determines that it is just and equitable to do so having regard to all the circumstances of the case.

- Under the Employment Ordinance, if an employer dismisses an employee without prior notice, the employee shall not be entitled to remedies for unreasonable and unlawful dismissal unless the employee has made a claim for such remedies by notice in writing to the employer within 3 months of the dismissal or has filed a claim with the Labour Tribunal within 9 months of the dismissal.

5 Who Can Sue?

If a director breaches these general duties, he may be liable to action by:

- 5.1 The company.
- 5.2 The members.

As the wrong is done to the company, the right to sue belongs to the company as a distinct legal entity and not to its member. This rule is commonly known as the rule in *Foss -v- Harbottle* ([1843] 2 Hare 461) and generally prevents the members taking action against the director on behalf of the company. There are exceptions to this rule, including :

- Where the act complained of was *ultra vires*.
- Where the action complained of was an invasion of a member's personal rights as a member.
- Where the wrong doer is in control of the company, so that it is impossible for the company to bring an action in its own name, an individual member may bring a derivative action against the director.

The legal system in Hong Kong presently do not cater for situations which in the United States that may be dealt with by "class action", but reform in this regard is in the pipeline.

- 5.3 The official receiver, or the liquidator, creditors or contributories of a company.

Under s276 of the Companies Ordinance, these parties may, upon application to the Court, bring an action against a director for breach of fiduciary duty where the company is in liquidation and there has been misfeasance, breach of trust or misappropriation or retention of company assets.

Under s275 of the Companies Ordinance, a person who is knowingly a party to fraudulent trading may, when the company is being wound-up and on an application to the Hong Kong Court by these parties, be personally liable for the company's debts or liabilities, as directed by the Court.

5.4 A third party

In *The Radiant* [1958] 2 Lloyds Rep. 596, a company's managing director was held personally liable for injury to an employee caused by permitting a ship to go to sea in an unseaworthy condition, in circumstances where he knew it was for him to ensure that necessary repairs were done and proper equipment provided.

5.5 Regulatory authorities.

For example, the Securities and Futures Commission is responsible for enforcing laws relating to the securities and futures industries. The SFC may commence criminal proceedings against a director who did anything with a view to creating a false or misleading appearance in active trading of any securities listed on the Stock Exchange of Hong Kong or with a view to creating a false market in those securities.

5.6 Employees

Under the Sex Discrimination Ordinance, certain discriminatory practices are prohibited (e.g. sex discrimination and sexual harassment in the employment field). If a director does an act or knowingly aids another person to do an act which is prohibited, the employee may claim against the director for damages.

6 What is the Enforceability of a Foreign Judgment on Hong Kong Directors, Officers and Managers under Hong Kong Law?

A foreign judgment may be enforced either under the Foreign Judgments (Reciprocal Enforcement) Ordinance or under Common Law.

Under the Foreign Judgments (Reciprocal Enforcement) Ordinance, a plaintiff who has obtained a judgment from a country which has a reciprocal enforcement arrangement with Hong Kong may apply to register the judgment in Hong Kong. The procedure is relatively simple. A registered foreign judgment has, for the purposes of execution, the same force and effect as if the judgment had been a judgment originally given by a Hong Kong Court.

A judgment obtained in a country which has no reciprocal enforcement arrangement with Hong Kong may not be enforced directly but will be regarded as creating a debt between the parties to it. Enforcement of a foreign judgment under Common Law is by way of an action for the amount of the judgment debt. Summary judgment may be given for the plaintiff unless the defendant can set up a credible defence. No legal action at common law may be brought on a judgment which is registrable under the Foreign Judgments (Reciprocal Enforcement) Ordinance.

7 Can the Directors, Officers and Managers be liable for punitive damages under Hong Kong law and are punitive damages insurable under Hong Kong law?

There are three categories of cases in which punitive damages may be available under Hong Kong law:-

- Oppressive, arbitrary or unconstitutional conduct by government servants.
- A case where the defendant's conduct was calculated to result in a profit for himself (e.g. the publication of defamatory statements made by newspapers in the course of its business for profit).
- Express authorisation by statute (e.g. under the Sex Discrimination Ordinance and the Disability Discrimination Ordinance).

There is no legislation in Hong Kong relating to the insurability of punitive damages. However, it is not clear that punitive damages are recoverable from an insurer, although there is an authority in the UK which suggests that it is recoverable (Lancashire County Council v Municipal Mutual Insurance [1996] 3 All ER 545).

8 Can the Company Indemnify its Directors, Officers and Managers under Hong Kong Law?

Section 165 of the Companies Ordinance permits a company to indemnify an officer against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in connection with an application to the Court under S358 of the Companies Ordinance where relief is granted to him. Subject to this exemption, section 165 states that any provision, whether contained in the Articles of Association of a company, or in any contract with the company or otherwise, exempting any officer of the company from, or indemnifying him against, liability for negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, is void.

9 Is Directors, Officers and Managers Liability Insurance Legal?

9.1 Is it legal?

It has been suggested that s165 of the Companies Ordinance may have the effect of preventing a company from insuring the liabilities of its directors and officers, subject to the exemption mentioned above. This provision has not been tested in the Hong Kong Courts, nor was the equivalent section tested throughout the many years that it constituted the law in the United Kingdom.

This provision has been reformed in some jurisdictions including the United Kingdom where companies are permitted to purchase insurance to cover the liabilities of their directors and officers. In November 1994, the Hong Kong Government appointed consultants to review the Companies Ordinance and the Consultancy Report on the Review of the Hong Kong Companies Ordinance was completed in March 1997. In respect of s.165, the consultants recommended that companies should be permitted to insure directors and officers except for any failure by them to act honestly and in good faith with a view to the best interests of the company.

The recommendation of the consultants was accepted by the Standing Committee On Company Law Reform (the “SCCLR”), which recommended that action be taken promptly to implement the consultants’ recommendation. The SCCLR further recommended that a company should be allowed to obtain insurance for directors’ liabilities save for fraud, but that insurance cover could include the cost of litigation irrespective of the outcome of such litigation and even if such litigation involved an allegation of fraud by a director.

As a result of the SCCLR's recommendation, it is proposed in the Companies (Amendment) Bill 2002 that a company may purchase and maintain for any officer of the company, or any person employed by the company as auditor:-

- (a) insurance against any liability to the company, a related company or any other party in respect of any negligence, default, breach of duty or breach of trust (save for fraud) of which he may be guilty in relation to the company or a related company; and
- (b) insurance against any liability incurred by him in defending any proceedings, whether civil or criminal, taken against him for any negligence, default, breach of duty or breach of trust (including fraud) of which he may be guilty in relation to the company or a related company.”

It is common to see two separate policies being put in place at the same time.:-

- Corporate reimbursement policy. This provides reimbursement to the company where it has indemnified a director as specifically permitted under the exemption to s165 referred to in paragraph 8 above and the Articles of Association of the company. The company will pay the policy premium which is reimbursed by the insurer in the event of a claim. As the director has in essence been found not guilty, the reimbursement is limited to costs and expenses.
- Directors and officers liability policy. This policy covers the directors (not the company). Cover includes costs and expenses and damages when judgment is awarded against the director. The usual practice is for the director concerned to pay the premium himself, or if the director is a nominee, for his appointor to do so.

9.2 The Extent of Cover – What can be Insured Against?

(a) Breach of Fiduciary Duty and Duty of Care and Skill

In the absence of criminal liability and of deliberate wrongdoing, insurance cover can indemnify directors for breach of these duties to the company.

(b) Criminal Liability

As stated in Britton –v- Royal Insurance Co [1866] AF and F905, there can, generally speaking, be no recovery under a policy of insurance where the act generating liability is a

criminal act. However, it is not clear whether this prohibition extends to strict liability offences where there is no real fault.

(c) Deliberate Tort and Misconduct

Since *Beresford –v- Royal Insurance Co* [1938] AC 586, it has been clear that an insured person cannot by his own deliberate act cause the event on which the insurance money is payable and so any deliberate breach by a director of his duties or any deliberate incursion of liability will not be covered by insurance.

(d) Ultra Vires

No insurance policy maintained by the company can indemnify its officers against liability for acts committed outside the scope of the company's Memorandum of Association. This is perhaps academic now as the ultra vires rule has been abolished in Hong Kong and a Hong Kong company now has the same powers as a natural person.

9.3 Location of the Insurer and Taxation

There is no legal requirement that an insurance policy for directors, officers and managers liabilities must be issued by an insurer licensed in Hong Kong.

The Inland Revenue Ordinance contains specific provisions for assessing the profits of insurance companies. Such assessment generally follows the financial accounts of the insurance company concerned, subject to apportionment of premiums between on-shore and off-shore business.

10 General Comments

The acceptance of a directorship is a serious responsibility. The company will need to consider the skills and other benefits that an individual can contribute and their price. A potential director will wish to consider the rewards of the job and his obligations to the company under the terms of his contract. He should also be mindful of the duties that he will owe once he accepts his appointment and will need to be quite satisfied that the environment he is about to enter is one which will enable him to perform those duties to the full.

An indemnity from the company backed up by insurance cover is a comfort, particularly if it can be structured in such a way as to enable the company to bear most of the cost whilst at the same time not jeopardising the cover.

Other steps can be taken in terms of the director's own conduct and the running of the business to minimise risk of criticism.

The bottom line is, however, that the potential liability of a director, unlike that of most shareholders, is unlimited.

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