SLAUGHTER AND MAY

Directors - personal liability for companies in financial difficulties

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This bulletin concentrates on the ways in which directors may find themselves personally liable for the debts of a company in financial difficulties.

Practical advice

As soon as the directors become aware the company is in financial difficulties they should seek professional advice, principally from the company's lawyers and financial advisers (and possibly from a licensed insolvency practitioner). A good starting point is to seek advice from the accountants who audit the company's financial statements.

Directors should have access to and review up-to-date management accounts in order to make informed decisions.

It is important to create and retain a paper trail that evidences directors have taken appropriate steps, including participating in board meetings and considering the relevant information and the potential steps to take. Directors should consider the interests of creditors on the basis that the company is approaching insolvency. The paper trail will include the preparation and approval of detailed board minutes.

It is rarely advisable for directors of companies in financial difficulties to resign. Usually, remaining on the board allows the directors to discharge their duties rather than being seen to walk away from problems. A different approach may however be required if there is disagreement between directors on the appropriate remedial steps to take.

Fraudulent trading

For obvious wrongdoing, fraudulent trading civil liability for the debts/liabilities of the company may be imposed on a director where the company is in the course of winding-up. Fraudulent trading, in respect of a company which is being wound up, is also a specific ground for a director disqualification order.

In addition, criminal penalties (being an unlimited fine and up to 5 years' imprisonment) may be imposed whether or not the company is being wound up.

The main thrust of fraudulent trading is where a person is knowingly a party to carrying on a business in a fraudulent manner (which encompasses an intention to defraud creditors).

This involves a high threshold to prove fraudulent intention and so fraudulent trading cases (whether through the civil or criminal provisions) are rare.

No wrongful trading regime in Hong Kong

Unlike other regimes such as the UK, there is no lower threshold liability 'wrongful trading' provision in Hong Kong. Although LegCo has discussed enacting such a provision, there is no current legislative timetable for its introduction in the near term.

Misfeasance and breach of duty

A more common route to director personal liability is for misfeasance or breach of duty to the company. Claims may be made for example for breach of fiduciary duties such as the duty to act bona fide in the best interest of the company and for breach of statutory duty to exercise reasonable care, skill and diligence.

A summary procedure is set out in section 276 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (**CWUMPO**) to enforce, in the course of winding-up a company, existing rights the company has against its officers (including directors) for wrongful conduct.

Examples of claims brought under section 276 CWUMPO are:

- Misapplication of money or assets of the company
- Breach of statutory duty such as unlawful loans to a director or entering into transactions at an undervalue
- Breach of the duty of skill and care (including failure to properly investigate red flags concerning the solvency of the company)
- Breach of the duty to exercise independent judgement.

A director who is found liable for misfeasance may be required to pay damages to the company.

Piercing the corporate veil

Although much commentary is written about piercing the corporate veil, the courts will only ‘pierce’ the separate legal personality of the company (and the liability of the company to third parties) and ‘look through’ to directors (or shareholders of limited companies) in exceptional circumstances. In nearly all cases, the third parties will be required to claim against the company.

The most obvious exclusion to this, where third parties may be able to claim against a director, is where the director has been fraudulent or (albeit more a shareholder risk) the company has been incorporated/used for a fraudulent purpose.

There are other more remote possibilities to attribute a director with liability. These include where: (i) the company acts as an agent for a director; or (ii) the director assumes personal tortious liability to the third party claimant. These are unlikely to apply in the vast majority of circumstances (and in particular are unlikely to apply in relation to companies which are not quasi-partnership in nature).

Unlawful distributions, redemptions and buy-backs

Directors who authorise unlawful payments by the company, such as an unlawful distribution, may be liable to account to the company for such payments.

Where the company has made a payment out of capital in respect of a redemption or buy-back, and the company commences winding-up within one of the payment, the directors may be liable to contribute to the company’s assets.

Keeping of accounting records, payments of MPF contributions, payments of wages

Directors may commit offences for:

- failing to take all reasonable steps to ensure the company keeps proper accounting records (the maximum liability is a fine of HK$300,000 and 5 years’ imprisonment)
- failure to pay MPF contributions (the maximum liability is a fine of HK$350,000 and 3 years’ imprisonment)
- wilfully and without reasonable excuse failing to pay wages to an employee (the maximum liability is a fine of HK$350,000 and 3 years’ imprisonment).

Personal guarantees

Directors of closely held smaller companies may well have given personal guarantees in respect of banking facilities.

Disqualification

The courts may disqualify persons from being directors under a number of grounds. Some of the grounds apply only where the company is in the course of winding up. Others, such as conviction of an indictable offence in connection with the management of the company, or persistent default in making returns or filings or in giving required notices to Companies Registry, are available whether or not the company is in the course of winding up.

The SFC may seek to disqualify directors of listed companies for misfeasance or misconduct by way of application to the courts.

Disqualification may be for a period of up to 15 years.

Going concern and viability statements

In practice, an obvious touchpoint for directors to consider the state of the company arises during the annual financial statements process when directors consider whether the going concern basis of accounting is appropriate. Directors should bear in mind the Hong Kong Institute of Certified Public Accountants (**HKICPA**) guidance when making this determination.

In respect of financial reporting implications of COVID-19, in March 2020 the HKICPA published update issue 33. The update states that for the purpose of the going concern assessment, management should consider the impact that the outbreak of COVID-19 and its associated events, which have occurred since 31 December 2019 (for a year-end accounting reporting period), has had on the entity. In particular, management should consider whether events after the reporting period related to COVID-19 have resulted in a need to consider whether the going concern assumption is still appropriate, and whether there are material uncertainties that may cast significant doubt on the ability to continue as a going concern.

The HKICPA update states that the information management should take into account when determining whether the going concern assumption is still appropriate includes:

(A) All available information about the future at least (but not limited to) twelve months from the end of the reporting period

(B) History of operations and access to financial resources

(C) Depending on the circumstances, a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing.

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