Introduction
The Institute’s Company Law Interest Group is one of seven groups set up in 2016 under the Technical Consultation Panel to look into key areas of corporate governance and company secretarial practice with a view to producing guidance to Institute members and the wider profession and community.

It has been over three years since the new Companies Ordinance (Cap 622) (New CO) became effective on 3 March 2014 with its codification of certain directors’ duties, as well as revising other related provisions. This first guidance note produced by the Company Law Interest Group aims to review these provisions under the New CO and look at how they have been implemented in practice.

Director’s Duties under the new Companies Ordinance
In Hong Kong, all Hong Kong incorporated companies are required to appoint a company secretary, in contrast to the UK where a private company is exempt from such a requirement. The company secretary discharges a multitude of roles, including being the trusted adviser to the chairman and board of directors. In this connection, the company secretary is frequently asked to provide views to the chairman and/board of directors as to whether the directors have individually and/or collectively discharged their director’s duties in relation to an array of matters. The company secretary should therefore be well versed in the basics of a director’s duties to be effective in providing advice to the chairman and/or board of directors which this guidance note summarises as a handy reference. It should be added that this extends to all non-Hong Kong incorporated listed issuers, which under Rule 3.08 of the listing rules must, as a minimum, apply Hong Kong law relating to director duties.

1. Duty of care, skill and diligence
Before the New CO came into effect, the general duties of directors were based on common law. The New CO has codified the director’s duty of care, skill and diligence in the performance of the director’s functions and the exercise of powers. The new regime adopts a dual-test as set out below.

- **The objective test** – on the one hand, a director is required to possess ‘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’. This is known as the objective test (see Section 465(2)(a) of the New CO).

- **The subjective test** – on the other hand, where a director is appointed due to some special knowledge, skill or experience, a higher standard of care, that is ‘the general knowledge, skill and experience that the director has’, will be placed on him compared to those without such knowledge, skill or experience. This is known as the subjective test (see Section 465(2)(b) of the New CO).

While the objective test sets a minimum standard for all directors which cannot be adjusted down, the subjective test imposes a standard that may be adjusted upwards for directors who are employed due to their special knowledge and skill.
The objective test lifts the standard a director is required to attain beyond what was adopted in *Re City Equitable Fire Insurance Co*, [1925] Ch 407 (a subjective standard according to the skill and experience that the particular director possesses).

The subjective test further lifts the standard for those directors who are appointed as a result of their specialised knowledge, skill or experience. Thus, the independent non-executive director of a Hong Kong incorporated listed company who satisfies the requirement under the listing rules of having the professional qualifications or accounting or related financial management expertise will thus be required to satisfy that higher standard of duty.

**Applicable persons**

The provisions under the New CO apply to all directors of a Hong Kong incorporated company, including shadow directors (see Section 465(5) of the New CO). A shadow director is a person in accordance with whose directions the directors, or a majority of directors, are accustomed to act. However, in this context of director's duty, a body corporate is not to be regarded as a shadow director of any of its subsidiaries by reason only that the directors, or a majority of the directors, of the subsidiary are accustomed to act in accordance with its direction or instructions (see Section 465(6) of the New CO).

The New CO does not distinguish between executive directors, non-executive directors and independent non-executive directors, although such distinction is seen in the roles of directors of Hong Kong listed companies. The Court of Appeal has stated (in the case of a private company) that executive directors and non-executive directors have the same responsibility in law as to the management of a company's business, and that the law does not have any regard to whether a director holds an executive position within the company (see *Law Wai Duen v Baldwin Construction Company Limited and Chan Shiu Chick & Others* [2001] HKCU 842). Indeed, as seen in the recent disqualification proceedings by the Securities and Futures Commission (SFC) against directors of listed companies who are in breach of the duty of care, skill and diligence under the listing rules, the SFC has not limited this to executive directors only.

**Consequence of breach**

The consequences of a breach of the statutory duty of care, skill and diligence have not been codified, so the common law rules and the equitable principles in respect of breaches of the duty will continue to be relevant.

Since the implementation of the New CO, two cases have been brought in Hong Kong courts on the breach of a director's duty of care, skill and diligence.

In the first case, the SFC brought disqualification proceedings against the directors of a GEM listed company, First China Limited, in connection with a payment to the seller of a company acquired by the listed company purportedly pursuant to a pre-completion mutual understanding which was held by the court not to have existed. The directors and former directors of the listed company were ordered to compensate the listed company for wrongfully causing it to make the above payment to the seller. This was despite the fact some of the directors did not personally gain from the wrongdoing.

In the second case commenced earlier this year, the company brought an action against its director and a senior manager for their failing to present cheques issued by a company which subsequently went bankrupt, and making up subsequent resale transactions to cover the loss. Judgment on whether the director was in breach of his duties has yet to be made.

**Relationship with existing common law and fiduciary duties**

The fiduciary duties of directors are not codified under the New CO. Thus, fiduciary duties, including acting in good faith in the interests of the company, exercising powers for their proper purpose, and avoiding conflict of duty and interest, remain in case law.

When determining whether a breach has occurred, various factors would be taken into consideration, including the terms of any service contract, the company's articles of association, and in the case of a company listed on The Stock Exchange of Hong Kong Limited, the standards as set out in the listing rules will also be relevant.

2. **Protective measures: exemption, indemnity and insurance**

When a breach has occurred or may have occurred, the company’s articles of association and the director’s service contract should be considered in order to see if there is any applicable exemption or indemnity. At the same time, if the company has purchased insurance for the director, the company should contact the insurance company to assess if the situation is covered by the insurance policy.
In practice, a director may incur liabilities in three different capacities:
1. as a director
2. as an officer other than director (for example a manager or company secretary), and
3. in a personal capacity.

It is critical to determine a director’s capacities while in breach of duty, as different rules of exemption and indemnity will apply to him/her.

**Exemption**
If directors have incurred liability whilst acting in their role as a director, the company may exempt their liability except where there has been negligence, default, breach of duty or breach of trust (‘proviso liabilities’) by the director in relation to the company. This position is the same as that of the old regime.

What is new is that exclusions from liability made in favour of managers or company secretaries are not covered by the new CO. Thus, if a director is not acting in the role as a director, there is no statutory prohibition for the company to exempt him/her from the Proviso Liabilities.

**Indemnity**
Similar to the position of the above exemption rules, there are no changes to the scope of duties that cannot be indemnified for liabilities incurred in the role of a director (that is the proviso liabilities).

However, indemnities provided to managers and company secretaries are no longer prohibited under the legislation. So directors acting outside their roles as directors may enjoy a wider scope of indemnity.

In addition, it is also important to differentiate whether the liabilities are owed:
1. to the company and its associated companies, or
2. to a third person.

For category (1), any indemnities to directors for the proviso liabilities owed to the company and its associated companies will be void. For category (2), the New CO provides that indemnities for liabilities owed to a third person are permitted as long as the indemnities do not relate to certain exclusions, such as criminal fines, penalties imposed by regulatory bodies, defence costs in criminal proceedings where the director is found guilty and defence costs of civil proceedings brought by the company or an associated company (the permitted indemnities under categories (1) and (2) above being referred to as ‘permitted indemnity provisions’).

Another point to note is the requirement for disclosure. Under the New CO, a company must disclose any permitted indemnity provisions which are in force in its directors’ report and a copy of such permitted indemnity provisions should be kept at the company’s registered office and be made available upon request by any shareholder of the company.

Timing of the provision of the indemnity is also important. In the First China case discussed above, the directors resolved that the listed company should provide an indemnity to two of the directors for all professional and legal fees incurred by them in the defence of the proceedings. The court found the indemnity to be ‘plainly inappropriate’ and ‘a very poor reflection’ on First China’s corporate governance. Consequently those two directors had to repay all such legal costs to the company. Thus, any indemnity a company wishes to provide for its directors should be set up as part of its corporate governance arrangements and not in reaction to claims having arisen.

**Insurance**
Instead of providing indemnification from the company’s own funds, the company may avoid such costs by purchasing insurance for a director so that it is the insurance company that will be paying the indemnification. The company may purchase insurance for a director at the expense of the company for
1. primary liability, and
2. costs of proceedings.

Compared to indemnification, the scope of liabilities covered by insurance can be wider since primary liabilities, including proviso liabilities (except for fraud), may be covered by

---

3 See s.468(2) of New CO.
4 See s.468(3) of New CO.
5 ‘associated company’ in relation to a body corporate, means—(a) a subsidiary of the body corporate; (b) a holding company of the body corporate; or (c) a subsidiary of such a holding company. See s.2 of New CO.
6 See s.469 of New CO.
7 See s.469 of New CO.
8 See s.470(1) of New CO.
9 See s.471 of New CO.
10 See s. 472 of New CO.
11 See s.468(4) of New CO.
insurance policies, and the costs of proceedings are even allowed to cover proceedings involving fraud. However, under common law, a court may invalidate an insurance contract on public policy grounds if it insures a director for regulatory or criminal fines.

If a director serves a listed company, the listed company is required under the Corporate Governance Code to purchase appropriate insurance to cover legal actions against its directors\(^\text{12}\), or alternatively must explain the reasons for the deviation from the above requirement in its interim\(^\text{13}\) and annual report\(^\text{14}\).

As protective measures, all of the exemption, indemnity and insurance coverage should be planned and implemented ahead of the any liabilities arising. The New CO indemnity and insurance provisions are reflected in the new Model Articles\(^\text{15}\), which may be helpful when drafting contractual indemnity provisions. In addition to the company’s articles of association (which constitutes a contract between the company and its shareholders), any exemption or indemnity provisions should also be set out expressly in the director’s service of contract or terms of engagement (which is a contract between the company and the relevant director).

3. Remedial measures: ratification

In addition, the company may consider ratifying a director’s breach, provided it is allowed by law. In the circumstances where a director’s breach falls within the proviso liabilities, the New CO allows a company to ratify the director’s conduct by:

1. shareholders’ resolution at a shareholders’ meeting (the director in respect of whose conduct the ratification is sought and his connected person cannot be counted for the vote\(^\text{16}\), but can be counted for the quorum\(^\text{17}\)), or
2. unanimous consent of all shareholders of the company\(^\text{18}\).

It should be noted that the ratification of the proviso liabilities can only be made by resolution of the shareholders of the company.

Alternatively, a director’s liability may also be released if the directors of the company decide to exercise the power to agree not to sue, or to settle or release a claim made by them on behalf of the company\(^\text{19}\).

The above rules also apply to a former director or a shadow director\(^\text{20}\).

---

12 Para. A.1.8 of Appendix 14 of the Listing Rules.
13 Para. 44 of Appendix 16 of the Listing Rules.
14 Para. 6.3(n) of Appendix 14 of the Listing Rules.
15 See Companies (Model Articles) Notice (Cap. 622H): Articles 31 and 32 of the new Model Articles for private companies; Articles 35 and 36 of the new Model Articles for public companies.
16 See s.473(3) of New CO.
17 See s.473(2) of New CO.
18 See s.473(6)(a) of New CO.
19 See s.473(6)(b) of New CO.
20 See s.473(5) of New CO.