Directors Of Insolvent Companies: Managing the Risk of a Disqualification Order

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Directors of Hong Kong companies operate in an environment of personal liability – a liability that is brought into sharp focus where companies face financial difficulties. This liability may take not only the form of criminal or civil liability but also the form of a disqualification order, meaning an order to bar that director from being involved in the management of a company in the future. In this article, we explore the basis for a disqualification order and provide guidance for individual directors as to how they should conduct themselves in times of financial stress to avoid liability.

By Timothy Loh and Mary Lam

Company directors operate in an environment of personal liability. Nowhere is this more clear than in the case where their companies face financial difficulties. In these circumstances, quite apart from potential criminal and civil liabilities, directors run the risk that if their conduct falls below the requisite standard, they may attract a disqualification order, meaning an order that the director be barred from serving as a director or from being involved in the management of a company for a period of up to 15 years except with the approval of the court. A disqualification order has far reaching consequences because it bars the individual from being a director not only of the company that has been wound up but also of other companies in the future.

Background

The jurisdiction for disqualification orders arises under a number of different statutes, the most significant of which for insolvency purposes is the Companies (Winding Up and Miscellaneous Provisions) Ordinance (“CWUMPO”). Though the circumstances for disqualification under CWUMPO vary from being convicted of an indictable offence or an offence involving dishonesty to persistent breaches of company laws, in the insolvency context, a director of a company being wound up or which has been wound up may be disqualified if:

- Fraud – he has been guilty of fraudulent trading or any fraud,
- Breach of Duty – he has been guilty of any breach of duty as a director; or

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Lack of Fitness – he is otherwise unfit to be concerned in the management of a company.

As a broad principle, disqualification proceedings generally take place at the behest of the Official Receiver on the basis of a lack of fitness. This type of disqualification proceeding is perhaps the most challenging type for directors as it need not involve a specific breach of a specific legislative provision. A disqualification order on this basis is justified because the court takes the view that a director’s misconduct is sufficiently serious that a disqualification is warranted to override individual freedom so as to protect the general public. As one court put it:

In addressing the question of unfitness, the court is to decide whether the conduct of which complaint is made, viewed cumulatively and taking into account any extenuating circumstances, has fallen below the standards of probity and competence appropriate for persons fit to be directors of companies.

Not every breach of duty or impropriety calls for a disqualification order. It would place directors of companies in an unfair and unrealistic position, and would involve going further than the applicable legislation or relative authorities contemplate, if every time a director was found to have failed in his duty, he was liable to be disqualified.

Process

Applications for disqualification orders under CWUMPO on the basis of a lack of fitness are normally made by the Official Receiver. However, the role of the liquidator of a company being wound up is significant for it is the liquidator who, through his day-to-day responsibility for a winding-up, is likely to find fault with the conduct of a director and report it to the Official Receiver.

A complaint by a liquidator however, is not by itself sufficient. In determining whether to seek disqualification, the Official Receiver must take a view as to whether it would be in the public interest that a director (or former director) be disqualified. In this regard, the primary concern of the Official Receiver is whether a disqualification is desirable to protect the public from the future conduct of the director in managing a company.

Lack of Fitness

Once the Official Receiver makes an application, the court will assess the director’s fitness, having regard to a number of different factors, including whether the director has committed any misfeasance or breach of any fiduciary or other duty in relation to the company or whether the director has misapplied or retained, or conducted himself in any way giving rise to an obligation to account for, any money or other property of the company.

In the insolvency context, for example, a court may have regard to whether a director was responsible for the insolvency of the company or any failure by the company to supply any goods or services which have been paid for (in whole or in part), or any unlawful disposal of the company’s property.

Breach of Fiduciary Duty

Where a company enters the insolvency zone, a director’s fiduciary duty requires him to take into account the interests of the creditors as a whole. A failure to do so may subject him to a disqualification order. For example, a director may be liable to be disqualified if he causes the company to give an unfair preference to a particular creditor (e.g. a payment to the creditor made with the desire to put that creditor in a better position than other creditors in the event that the company goes into liquidation), such as by making a loan repayment to a particular creditor at a time when the company owes outstanding wages to its employees and other payments to its general creditors. Equally, for example, a director may be liable to be disqualified if, despite the company’s financial difficulties and without lawful reason, he withdraws funds from the company for personal use and with no benefit to the company. Finally, for example, a director may be liable to be disqualified if he draws and tenders cheques for payment to the company’s
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creditors knowing that the company has insufficient funds in its bank accounts to honour those cheques.

One area of difficulty is the extent to which a director may be subject to disqualification if he continues the company’s business in the face of insolvency. In one case, directors were disqualified on the basis that they had caused the company to make large purchases of stock at a time when they knew the company had ceased to be viable. In another case, a director was disqualified when he caused the company to take deposits from customers for sale transactions knowing that the company could no longer fulfill those transactions.

Statutory Breaches

As there is some uncertainty as to whether a director’s conduct warrants a disqualification order in the absence of a breach of a specific statutory provision, it is common for disqualification proceedings on the basis of lack of fitness to include allegations of breaches of specific statutory duties to strengthen the case for disqualification. This is particularly so where, in the insolvency context, such breaches speak to a disregard for the interests of creditors or obstruct the winding-up process.

Thus, for example, a director’s failure to cause proper accounting records to be kept may form the basis for a disqualification order as such failure hampers the director’s ability to understand the financial status of the company and make decisions accordingly and, in the event that the company ends up in liquidation, the liquidators’ ability to identify and recover the assets of the company. Similarly, for example, where a director fails to ensure that a company pays its employee’s wages or its contributions to the Mandatory Provident Fund, or renews its employee compensation insurance, a court may make a disqualification order against that director. Finally, for example, where a director fails to maintain proper corporate records and to make proper filings with the Companies Registry, he may be the subject of a disqualification order.

Breach of Duty of Care

A director’s breach of his duty of care may provide the basis for a disqualification order. However, where the case for a disqualification order is based solely on allegations of incompetence, the court must be satisfied that either the conduct complained of demonstrates incompetence to such a high degree that allowing the individual to act as a director would endanger the public or the conduct breaches standards of commercial morality.

It follows that mere commercial misjudgment is insufficient to justify a disqualification order. Thus, for example, where a director causes a company to pursue a line of business which ultimately fails, without more, it would be unlikely that the director could be subject to a disqualification order. On the other hand, for example, a director could be liable to disqualification if he habitually approves transactions without understanding the substance or ascertaining the purpose of these transactions or he fails to make enquiries or exercise independent judgment as to whether these transactions are in the interest of the company.

One area that may concern a director is whether he could be liable to disqualification on the basis that those to whom he has delegated management responsibility fail to meet the requisite standard of conduct. In this respect, a court will have regard to the role which a director was assigned (or which he in fact assumed) in the management of a company in determining whether he has been unfit. Non-executive directors should not, however, draw too much comfort from this approach for this approach does not absolve them to act prudently. So, for example, a non-executive director may be liable to disqualification if he approves a transaction knowing that the transaction would have a long-term substantial impact on the company’s financial position without making sufficient enquiries about the transaction and simply deferring to the executive directors without exercising his own independent judgment to question the commercial viability of the transaction.
“[A] non executive director may be liable to disqualification if he approves a transaction knowing that the transaction would have a long-term substantial impact on the company’s financial position without making sufficient enquiries about the transaction and simply deferring to the executive directors without exercising his own independent judgment to question the commercial viability of the transaction.”

**Conclusion**

The pressure from financial difficulties faced by companies can impair the ability of the directors of those companies to make sound judgments that comply with the law. The temptation to cut compliance corners to save costs, the desire to move quickly to ensure corporate survival and an undue optimism as to the probability of the success of life saving strategies are factors that can increase the risk of a director’s personal liability and result in the director being subject to disqualification. In these circumstances, whenever there is doubt, directors should consider the need for objective and professional external advice to ensure they remain on the right side of the law.