



Newsletter Nr. 180 (EN)

**A Hong Kong Company's Board of Directors
- Function and Liabilities -**

January 2019

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I. Introduction

This Newsletter has been drafted to provide an overview of the functions, powers, duties and liabilities of the Board of Directors (“**BoD**”) of a limited company in Hong Kong. Only the regulations applicable to private companies will be elaborated herein. The stricter and more complex rules concerning public and especially listed companies are solely covered in footnotes.

II. Structure of a Limited Liability Company

To understand the BoD correctly, one has to understand the structure of a limited liability company in Hong Kong.

A Hong Kong limited liability company basically consists of three parties:

- The shareholder i.e. the owners (also called members);
- The BoD which is composed of the company’s directors; and
- the Company Secretary

Principally any natural and/or juristic person can be shareholder and/or director, as well as Company Secretary. The capital of the company does not have to be (fully) paid up and no interest incurs on outstanding capital. It is only if the BoD makes an official payment request that the money must be paid in

There are 7 different types of capital:

- (1) **Registered Capital:** This is the capital which the Articles of Association (“**AoA**”) state is the capital of the

Company, which is registered and divided into shares.

- (2) **Authorised Capital:** The maximum capital of the company.
- (3) **Issued Capital:** The sum of Authorised Capital that has actually been issued by the company (via shares). The Issued Capital is always equal to or lower than the Authorised Capital amount.
- (4) **Paid up (or paid in) Capital:** The capital which the shareholders have already paid in and made available to the company.
- (5) **Outstanding Capital (uncalled capital):** The capital which has been authorised as the company’s capital but has not yet been paid in by the shareholders. In Hong Kong, no interest has to be paid on outstanding capital.
- (6) **Equity Capital:** This is the capital which is contributed by the owners (the shareholders), added or subtracted by accumulated gains and losses. Equity is the residual value of the business enterprise that belongs to the shareholders. The value of equity capital is computed by estimating the current market value of assets (cash capital plus fixed assets) owned by the company which the total of all liabilities is subtracted from.
- (7) **Debt Capital:** Debt capital is the capital which has been loaned given to the company by third parties and which is expected to be repaid (e.g. banks, financial institutions or shareholder loans).

III. Functions of the BoD

1. The Board's General Duties

The BoD is the company's governing body and defines the principal direction of the company, in the best interest of the company (which is not necessarily identical to the shareholders' interests). The BoD also selects and supervises the managers of the company who have to implement the BoD's decisions.

The BoD's tasks involve:

- Preparation and execution of decisions by the Annual General Meeting ("AGM");
- Determining long term strategic objectives and policies;
- Appointment of the management, determination of the management structure;
- Supervision of the management. Taking corrective action if long term objectives are not sufficiently executed.
- Reporting to the shareholders about the company's activities.

A BoD resolution will be passed if it is approved by a simple majority of votes.

Depending on the size of the company some tasks may be delegated to committees or the management. However, the ultimate responsibility for such delegated tasks remains with the BoD.

2. Members of the Board

Any person occupying the position of a director and fulfilling the respective tasks is regarded a director even if no official appointment has taken place.

Specifically, if a person, acts like a director towards third parties (external representation of a company), the company will be bound

by contracts entered into by him, as if this person had the actual authority of a director. This is known as the "*Turquand rule*".¹

If the BoD continuously acts in accordance with the instructions of a person who is not appointed as a director, then this person is a "shadow director" and therefore also regarded as a director.

All directors on the BoD share the same basic responsibility. However, the Articles of Association can specify different positions in the BoD.

For example, nearly every company appoints a BoD Chairman to organise and preside over board meetings. He also acts as the BoD's representative to the outside. Further, a Managing Director is often appointed, to act as the head of the administrative/management structure and to be responsible for the implementation of the BoD's instructions and goals.

To fulfil their duties, the Chairman and the Managing Director are given additional powers and rights by the BoD. It is also possible for one person to hold both positions. Whether this is suitable depends on the respective company.

It is important to pass a BoD resolution, which determines who has signing authority for the company's bank accounts.

To ease the working procedures, it is also possible to give a power of attorney (Annex 1) to a member of the BoD or a third person. The power of attorney must include the following particulars:

- Start and end date of the power of attorney;
- Extent of the authority;
- Whether it is possible to issue sub-authorisations; and

¹ Royal British Bank vs. Turquand (1856)

- Revocation of the authority (the safest option would be to include a right to revoke the authority at any time.)

3. Powers and Duties of a Director

Regarding the powers and duties of directors it is necessary to differentiate between private and public companies.

(1) Private Companies

Private companies are companies in which the shareholders have only limited rights to assign their shares. The number of shareholders is restricted to fifty and offers to the public to subscribe for shares are prohibited (Section 11 Companies Ordinance). Concerning private companies Hong Kong's Companies Ordinance and non-statutory guidelines have to be considered.

(2) Public Companies

A public company is one which is not a private company, i.e. it does not fulfil the criteria mentioned above².

(3) Powers of a Director

The company's powers are derived from the law and from its AoA. These powers are delegated to the BoD. The powers and duties of the directors are therefore set out in the Articles of Association. This includes all powers necessary to exercise the duties of the BoD.

The directors have the right to call board meetings and to be notified of scheduled meetings. If any director is not notified of a BoD meeting, then all proceedings which

are carried out therein are void. In order to conduct business at a BoD meeting a certain

quorum of directors must be present (depending on the Articles of Association).

It is also possible to hold a "paper meetings" which by circulating resolutions between the director (e.g. by post or email), so that the physical presence of the BoD members is not required.

Minutes of the meeting must be taken for every BoD meeting. These minutes must be kept in the company's registered office by the Company Secretary. A failure to comply with this rule can be subject to a daily fine.

All directors bear equal responsibility for the decisions made by the BoD, even if they did not agree with and/or voted against it. The only way to escape this responsibility is if the director declares his resignation before the vote. Further, once the BoD has issued a decision, a director is obliged to comply with it.

If a director deems a decision to be commercially unwise, this should be discussed and recorded in the minutes. Depending on the Articles of Association the director may have the right to call a board meeting for such purpose. If the director does not have such a right, he can still seek support from the shareholders to call for an Extraordinary General Meeting ("EGM") in order to resolve the issue.

If a director, regards a decision not just as commercially unwise but also as unlawful, it is his duty to take action against it. In doing so he may seek internal and external help and support. The company's auditors, the shareholders or the financial secretary³ could provide such help.

² In the case of a public company the Companies Ordinance contains stricter rules. For listed companies additionally the regulations of the HKEx rules, securities ordinance, securities and futures ordinance will apply. For public companies the non-statutory guidelines are also relevant.

³ Concerning public companies, organisations such as the HKEx, the Securities Commissioner or the Panel on Takeover & Mergers come into consideration.

The directors are entitled to any information necessary to fulfil their functions. For in-

stance, a director has access to the management accounts and statistical reports in order to supervise the management, business plans and budgets and determine the company's policy.

A director requires the shareholder's approval to issue shares of the company.

(4) Duties of a Director

The directors exercise their rights as fiduciaries of the company. From this fiduciary position arises several basic duties.

Basic Duties

- The director has to act bona fide for the benefit of the company. It can sometimes be difficult to define the interests of the company. Both the long- and short- term interests of the company have to be taken into consideration. Also, the relationship between a parent company and subsidiary can put the director in a difficult situation. In this case the director owes his duty primarily to the company to whose board he is appointed.
- The director has to exercise his powers for their proper purpose. The powers which are given to the director by the Articles of Association must only be used for purposes for which they were intended.
- Conflicts of interests (i.e. between the company's interest and a director's personal interests) have to be avoided. A director must not take personal advantage of the company's opportunities. The court requires a high standard of honesty from fiduciaries. Secret profits, which a director makes in course of his function through the use of a corporate opportunity, which are not disclosed to the

company will be forfeited to the company.

The fiduciary position of a director may make it necessary for them to declare his interests to the company. For example, he may be required to declare if he holds shares in another company.

The execution of contracts between a director and the company is particularly vulnerable to conflicts of interest. As such the Companies Ordinance contains complex rules prohibiting the grant of loans or similar transactions in favour of a director or a person connected to a director.

The *general rule* is that a company may not grant a loan or provide any security in connection with a loan to a director or a company controlled by a director.

A *private* company however can via an AGM or EGM resolution grant loans to its directors. Furthermore, a company whose ordinary course of business includes granting loans and securities is also permitted to grant a loan to its directors without a resolution as long as this transaction is part of the ordinary course of business. In other words, the director cannot be given lower rate, favourable terms etc. for the loan in question. However, these exceptions only apply if the total liability of the company under all issued securities does not exceed 5% of its net assets.

Standard of care and skill

The standard of care and skill which a director is subjected to whilst fulfilling his duties and tasks is discussed in *RE City Equitable Fire Insurance Co Ltd (1925)*. The court laid down three points, which summarise a director's duty of care.

- A director, in the performance of his duties, does not need to apply a greater degree of skill than may be reasonably expected from a person of his knowledge

and experience. He has to exercise a degree of diligence like an ordinary man

might be expected to apply in looking after his own interests in the particular circumstances.

- A director is not bound to attend all BoD meetings, though he ought to attend whenever he is reasonably able to do so. Due to the intermittent nature of his duties he is not obliged to give continuous attention to the affairs of his company.
- In respect of all duties that may be transferred to another official a director is, in the absence of grounds for suspicion, justified in relying on that official to perform such duties honestly.

In *Secretary of State for Trade vs. Baker (No 6) (1999)* the court elaborated three other points.

- The directors have both collectively and individually a continuing duty to acquire and maintain a sufficient knowledge of the company's business to enable them to properly discharge their duties.
- The power to delegate particular functions does not discharge a director from his duty to supervise the execution of the delegated functions.
- For these duties, no universal application can be formulated, the extent of the duty depends on each particular case, including the director's role in the management.

Under the new Companies Ordinance (Section 465), for the first time, there is a certain statute provision determining a mixed objective and subjective test that determines the standards for director's duties.

Directors Report

At the end of each financial year the directors must prepare a report in respect of the profit and loss of the company for that year and the state of the company's business operations. The report must be approved and signed by the BoD. It is then attached to the balance sheet, which is presented to the shareholders at the next AGM or EGM. It must also be sent to everybody entitled to receive it, 21 days before the said meeting takes place. All shortcomings whether in signing the report or in above mentioned requirements will result in repercussions, such as fines or even imprisonment.

IV. The Board's Liability

It is possible to impose unlimited liability onto the directors in the AoA, meaning the amount of damages to which a director can be held liable by the company or third parties is not limited. In a limited liability company only the liability of the shareholders is limited.

Any exemption or indemnification of a director's liability whether it is in the Articles of Association or any other contract in regards to negligence, default, breach of duty or breach of trust, is void.

The AoA make it possible to indemnify a director against liability he has incurred whilst defending proceedings against him, in which judgment is given in his favour. Further protection can be achieved through Directors & Officers" liability insurance ("**D&O**").

Furthermore, the Companies Ordinance provides a number of sanctions in case of noncompliance by directors, including "shadow directors".

1. Internal Liability

China Everbright-IHD Pacific Ltd vs Ch'ng Poh (2003) concluded that the director is liable for any loss to the company due to his

breach of duty. If a breach of duty is committed by several directors, they are jointly and individually liable.

2. External Liability

As a basic principle, the company as a legal entity is solely liable for external debts and obligations. Consequently, a director has no personal liability towards the company's creditors, as long as he clearly acts on behalf of the company. There are a few exceptions to this principle.

If a director knows or ought to have known that their dormant company (as defined in the Companies Ordinance) has entered into certain transactions, then they will be personally liable for any consequential debts and obligations of the company. Where a company commits a criminal offence the director who is in control of the relevant activity may also be indictable. Further directors can also incur personal collateral liability e.g. by executing a personal guarantee in support of a corporate loan.

V. Insurance Coverage

A director may be exposed to accusations of breach of duty and related demands of damages from various sources. Such claims may be made by the shareholders, employees, creditors, authorities and auditors of the company. Insurance coverage against such accusations can be achieved with a D&O policy which is usually purchased by the company for its directors and covers damages and defence costs (lawyers, expert witnesses, court fees, etc.) for claims from contract partners, creditors and even shareholders of the company against the named director.

As noted above any provision which fully exempts or indemnifies a director is void under Hong Kong law. This includes insurance coverage. However, a D&O policy which covers damages and defence costs ex-

cept in the case of fraud in relation to the company or third parties is valid.

VI. Appointment/Removal of a Director

This section shall elaborate upon how a director is appointed into his office and how he can be removed from it. The possibility of disqualification of a director either by the board or by court shall also be explained.

1. Appointment of a Director

Both the appointment and removal of a director is conducted at an AGM/EGM. The procedure under which a director is appointed is determined in the Articles of Association. Usually the company's first directors are named in the Articles.

Technically directors may also be appointed by the BoD when there is a casual vacancy to be filled, or the total number of directors set out in the AoA is not exceeded. However the appointment must then be approved in the next AGM/EGM. A formal confirmation should be issued to any newly appointed director (Annex 2).

2. Removal of a Director

A Director may be removed by passing an ordinary shareholder resolution. The company must notify the Companies Registry of the removal. Unlike appointments, the BoD has no authority to remove a director.

To ensure that a director does not remain in office against the will of the majority of the shareholders no shares may carry higher weighted voting rights for a resolution to remove a director than it would carry for a resolution on general matters.

A notice of the intention to pass such a resolution must be given to the company at least 28 days prior to the relevant AGM/EGM. The director must also be notified at least 21 days in advance of the meeting.

The director concerned has the right to speak at the meeting. He is also entitled to communicate his point of view to the members of the meeting in writing.

Depending on the circumstances a director may be able to claim compensation or damages as a result of his removal from office.

Finally, if the Director is also an employee then the shareholders should consider whether such a removal would breach their service contract.

3. Disqualification of a Director

A director may be disqualified in accordance with the Articles of Association or the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32).

Most Articles state that a director will be disqualified if they are of unsound mind, bankrupt, fails to attend BoD meetings on a regular basis or is asked by all other directors of the board to resign. Cap 32 lists a number of standard reasons for the disqualification of a director.

According to the Companies Ordinance (Cap 622, Section 480) it is an offence, punishable with a fine and/or imprisonment, for a person to act as a director if they are an undischarged bankrupt.

The court may issue a disqualification order against a person, for a specified period of time ranging from 1 to 15 years. Such an order prevents a person from acting as a director, liquidator or manager of a company or to be directly or indirectly concerned with the setting up or management of a company for the specified period.

The grounds upon which a person may be disqualified by the court include if a person is convicted for an indictable offence in connection with the formation, management or liquidation of a company or any other indictable offence his conviction for which

necessarily involves a finding that he acted fraudulently or dishonestly.

If after an investigation the financial secretary thinks it is justified and in the public interest, he may apply for a disqualification order against a director or shadow director.

It is an offence and punishable by fine and/or imprisonment to not comply with a disqualification order. This not only concerns the person against whom the disqualification order was issued but also the company and its officers. A person who is involved in the management of a company in contravention of a disqualification order or who knowingly acts on the instructions of a disqualified person will be liable for all consequential debts incurred by the company.

VII. Resignation of a Director

A director may resign from office at any time, so long as the Articles of Association or the director's service contract do not provide otherwise. Following *Glossop vs Glossop (1907)* upon giving notice of the resignation it becomes immediately effective and cannot be withdrawn. In *Latchford Premier Cinema Ltd vs Ennion (1931)* it was held that this was the case even if the resignation was given verbally.

The resignation has to be sent to the registered office in written form. Afterwards the company has to notify the companies' registrar to notify them of the registration.

VIII. Consequences of a removal/resignation

If a director is removed by an AGM/EGM, his right to compensation or damages for the loss of office are not affected.

Damages, in case of a fixed term contract, are calculated according to the salary which would have been paid during the remaining term of the contract.

If the contract stipulates the remuneration on a per day or per year basis, the director is entitled to an appropriate part of his annual salary, when his office ends. In *Healy vs Francaise Rubastic SA (1917)* the court ruled that the director was even entitled to this payment, even if the reason for vacating his office was the director's own misconduct.

Bona fide payments to a director as compensation for breach of contract or as pension in respect of past services do not need to be approved by a shareholder meeting, whereby a special approval in terms of procedures is required (Sections 518 and 521 CO).

If, however, the company makes a compensation payment for loss of office or in connection with retirement from office, the approval of a shareholder meeting is required. Shareholder approval is also required, if the payment is made in the form of a transfer of property or shares.

In respect of retirement benefits and pensions it must be borne in mind that the company cannot take any action which is not in its own interest or for its own benefit. Therefore the payment of pensions has to be line with the company's objectives as defined in the Articles of Association.

IX. Conclusion

This short summary can only provide a brief introduction to the provisions concerning BoDs in private companies. The aim of this summary is to illustrate the fundamental principles which all limited companies have in common. Depending on the type of company and the circumstances of the particular case, the regulations and judicature may be far more complex than described herein and have to be adjusted to the respective company.

*We believe that the information provided was helpful for you.
If you have any further questions, please do not hesitate to contact:*

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Annex 1

POWER OF ATTORNEY TO WHOM IT MAY CONCERN

[.../name of the company],

a company incorporated under the laws of the Hong Kong S.A.R and having its registered office located at [...] (hereinafter referred to as the "PRINCIPLE") is desirous to appoint a person as its true and lawful attorney with powers as described below, being empowered to manage the interests, activities, programs and affairs of the PRINCIPLE in such manner as it deems fit, and in particular to appoint and remove attorneys and to delegate to this person powers and authorities of the PRINCIPLE.

The PRINCIPLE does hereby make, constitute and appoint

Mr. [...], born on [...]

Holder of [...] nationality Passport No. [...]

currently residing at [...] (hereinafter referred to as "ATTORNEY") to be the PRINCIPLE's true and lawful attorney, and to act as such in full compliance with the policy of the PRINCIPLE and any decisions and instructions given by the Board of Directors of the PRINCIPLE and/or the managing director of the PRINCIPLE and any other restrictions contained in this Power of Attorney:

1. To act as the GENERAL MANAGER of the PRINCIPLE and to direct, manage and/or superintend the PRINCIPLE's business affairs in Hong Kong and in Mainland China, and to employ and discharge employees, purchase, take on by lease or otherwise acquire and hold office space and procure supplies, materials and equipments needed for the business of the PRINCIPLE.

Any purchases in the name of the PRINCIPLE exceeding per case in total EUR [...] (says: EUR [...]) shall require the prior written approval of at least one director of the PRINCIPLE.

2. To conclude proceedings, negotiate, execute and deal with any Hong Kong government ministry, department, office and/or other governmental authority, and secure necessary permits, licenses and/or concessions for the business of the PRINCIPLE as well as execute and certify corresponding documents.
3. To endorse or deposit to the PRINCIPLE's credit in bank's cheques, drafts, monies, notes, and other evidence of value; to draw and sign cheques against such deposits for such moneys as may be necessary from time to time in the transaction of business.
4. To commence, file, prosecute, defend and carry to completion of all actions or legal proceedings at all levels in the Hong Kong courts or before other tribunals and Hong Kong

governmental organizations which the PRINCIPLE may have, both civil and criminal, involving any parties, including bankruptcy and liquidation proceedings against any natural or juristic person, and if, in the discretion of the ATTORNEY, it seems wise, to settle or compromise, refer to arbitration, or take such other steps as may be suitable in the foregoing, including the power to receive money or properties from any court, governmental organization, administration tribunal or natural juristic person.

5. To accept bills of exchange, borrow money by loan or overdraft, pledge the credit of the PRINCIPLE, encumber the property of the PRINCIPLE as security thereof in the way of pledge, mortgage, or hypothecation, to issue trust receipts and execute agency agreements.
6. To substitute and appoint an Attorney or Attorneys to perform any of the purposes aforesaid as the ATTORNEY deems fit and to revoke such appointment in his discretion and to appoint another substitute or other substitutes from time to time.
7. In general, and within the boundaries hereof, to do all other acts, deeds, matters and things whatsoever for all or any of the purposes aforesaid as amply and effectively to all intents and purposes as far as the PRINCIPLE might or could have done if he had acted personally.

This Power of Attorney shall be effective

from [.../its date of execution]

and shall

expire on [...],

unless prolonged in writing by the PRINCIPLE prior to the above expiration date.

IN WITNESS WHEREOF, the PRINCIPLE has caused this Power of Attorney to be executed in its name and on its behalf, and its corporate name and seal to be affixed.

For the PRINCIPLE

Mr. [...]

AUTHORISED SIGNATURE

Director

WITNESS

Mr. [...]

AUTHORISED SIGNATURE

Director

WITNESS

For the ATTORNEY:

MR. [...]

WITNESS

Annex 2

Appointment Letter

Dear Mr./MS. [NAME],

On behalf of the Board of [COMPANY NAME], I write to invite you to accept appointment as a director of [COMPANY NAME].

It is proposed that, on receipt of your signed consent to act, you will be appointed to the Board until the next Annual General Meeting which is scheduled to be held on [DATE]. The Board intends that you should be nominated for election by the shareholders at that meeting for a period of [DURATION]. At the conclusion of that period you will be eligible for re-election. The composition of the Board is reviewed annually by the Nomination Committee in order to ensure that the membership of the Board is in the best interest of [COMPANY NAME]. It is normal practice on this Board for directors to serve no more than [NUMBER] terms of [DURATION] each.

The Board schedules regular meetings, usually on [DATE], which last approximately [DURATION]. There is an annual two-day board conference and additional meetings may be called to deal with urgent and important matters. The attendance of directors is expected at all board meetings unless a leave of absence has been previously agreed with the Chairman. It is expected that each director will serve on at least one board committee. Over the past few years the time spent on their duties by members of the Board has averaged [TIME] per year. No special duties apply to your appointment.

Currently the remuneration of directors is [CURRENCY] [VALUE] per annum, paid monthly in arrears. Additional fees for committee work or other special activities are [CURRENCY] [VALUE]. No retirement benefits are provided. Expenses incurred in the discharge of a director's duties may be reclaimed by submission of a written claim which should be sent to the [PERSON RESPONSIBLE] and countersigned by the Chairman.

The Company indemnifies directors and pays part of the premium for a Directors' and Officers' Liability Insurance Policy. A copy of the arrangements is enclosed.

The directors have agreed to be bound by the enclosed Board Protocol which covers such matters as the duties of directors, confidentiality, and access to expert advice at the company's expense, contracts between directors and company executives, the handling of conflicts of interest and the positions of the Chairman and the Company Secretary. You will note that if a director should breach the Protocol, he/she would be expected to resign.

A copy of the Company's Memorandum and Articles of Association, a list of the other directors with brief CV's and a copy of a company organization chart are attached hereto for your information.

Yours sincerely,
[NAME]

Chairman