

More Directors' Duties?

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Director's duty of care, skill and diligence

- A director of a company must exercise reasonable care, skill and diligence [section 465(1) of Companies Ordinance (Cap.622) ("new CO")].
- Mixed objective and subjective test [section 465(2)] –
Reasonable care, skill and diligence that would be exercised by a reasonably diligent person with
 - (a) objective test – the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions of the director in relation to the company; and
 - (b) subjective test – the general knowledge, skill and experience that the director has.



Changing market, changing law

- For good corporate governance, modern corporate world expects more from directors.
- Subjective test as contained in old case law considered too lenient nowadays.
- Section 465(2) reflects the judicial trend to adopt a mixed objective and subjective test.
- Section 465(2) is modelled on section 174(2) of UK Companies Act 2006 ("CA 2006") and reflects similar provisions in other jurisdictions.



What does the mixed test mean? (1)

- Any breach ?
A director's conduct will be considered by applying both the objective test and subjective test. New objective test introduced.
- No uniform standard for all
What is required of directors will vary between different types of directors (i.e. functions carried out by the directors) and between different types and sizes of companies.
- Courts may have a greater role in defining the functions of the board and directors.

What does the mixed test mean? (2)

- The UK Government explained in the UK Parliament in 2006 the mixed test in section 174 of CA 2006 –
 - The tests (objective and subjective) are cumulative.
 - A non-executive director who is a lawyer by profession but not employed by the company in that capacity would not be expected to act as if he were the legal adviser to the company. But he would be expected to use his general legal knowledge to look at things when carrying out his functions as a non-executive director of the company.

[*Hansard*, HL, GC col 284 – col 285 (6 February 2006) and *Hansard*, HC Comm D, col 602 – col 604 (11 July 2006)]

Application – Case 1 (Below Standard Cases)

Q1 : Can a director's personal attributes justify a lower standard of care ?

- *Gamble v Hoffman* (1997) 24 ACSR 369 –
 - Respondent Mr H contended that when assessing whether he had exercised due care and diligence, the court should take into account that he left school at the age of 14 and had no tertiary qualifications and spent his life “essentially as a fruit and vegetable market gardener”.
 - Though the case was not decided on this point, the judge expressed reservations about whether subjective considerations of that nature and extent should affect the minimum content of the duty or standard of care required of the respondent, as the test is essentially objective.

Application – Case 2 (Director with special expertise)

Q2 : Will a director with special expertise be worse off under the mixed test than under the purely subjective test ?

- No. A purely subjective test will take into account a director's personal and special knowledge, skill and experience. Same under the subjective limb of the mixed test.
- *Re Continental Assurance Co of London plc (in liquidation); Singer v Beckett* [2001] BPIR 733 –
 - Liquidators of an insurance company claimed against directors for wrongful trading under section 214 of Insolvency Act 1986 ("IA 1986"), alleging that the directors ought to have known that certain accounting adjustments needed to be made but had not been made.



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Application – Case 2 (Director with special expertise) (cont'd)

- The court's ruling –
 - the accounting concepts involved were highly specialized and sophisticated. It would set the standard required of the directors at an unrealistically high level if they were expected to know the sort of accounting concepts as submitted by the liquidators;
 - while the liquidators' arguments would be appropriate in an action alleging professional negligence against accountants, such arguments are inappropriate in the claims against the directors;
 - the 2 non-executive directors with chartered accountancy qualifications (non-practising) should be regarded as intelligent laymen rather than professional accountants for the purpose of section 214 of IA 1986.



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Application – Case 3 (Financial Statements)

Q3 : What is the standard of knowledge and skill required in relation to financial statements ?

- *Re Continental Assurance Co of London plc (in liquidation); Singer v Beckett* [2001] BPIR 733, Park J –
 - Directors need to have knowledge of what the basic accounting principles for an insurance company were.
 - Would be expected to look at the company's accounts and, with the guidance from the finance director and the auditors, to understand them.
 - Would be expected to be able to participate in a discussion of the accounts, and to ask intelligent questions of the finance director and the auditors.

Application – Case 3 (Financial Statements) (cont'd)

- *Australian Securities and Investments Commission v Healey* (2011) 278 ALR 618 –
 - Case involved misstatements in financial statements of group companies. ASIC applied for declarations of contravention in relation to, *inter alia*, section 180(1) (care and diligence) of Corporations Act 2001.
 - 7 defendants (except one who was CEO) were non-executive directors.



Application – Case 3 (Financial Statements) (cont'd)

➤ Held –

- the defendants had contravened their statutory duty of care and diligence by approving the consolidated financial statements;
- directors have an objective duty of skill, competence and diligence that requires them to be able to read and understand financial statements;
- must, at least, understand the terminology used in the financial statements and understand that financial statements classify assets and liabilities as current and non-current, and what those concepts mean. This classification is relevant to the assessment of solvency and liquidity.



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Application – Case 4 (Delegation)

Q4 : To what extent can a director delegate his functions ?

- In *Daniels v Anderson* (1995) 16 ACSR 607, when considering the extent to which directors are justified in trusting and relying upon officers of the company, Clarke and Sheller JJA stated that –
 - The approach in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 that directors' duties may be left to some other official in the absence of grounds for suspicion etc "does not accurately state the extent of the duty of directors, whether executive or not, in modern company law".



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Application – Case 4 (Delegation) (cont'd)

- Delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
- No universal rule.
- In relation to annual financial report, directors cannot delegate their responsibilities to declare that the financial statements are in compliance with the company law but are entitled to –
 - delegate various tasks to others;
 - rely on specialist advice.

[ASIC v Healey (2011) 278 ALR 618]



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Examples of new disclosure requirements under the new CO (1)

- Directors' report must include –
 - Business review.
 - Information on equity-linked agreements.
 - A summary of the reasons for resignation or refusal to stand for re-election of a director.

[sections 388, 390, 391, 470, 543 of and Schedule 5 to new CO]



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Examples of new disclosure requirements under the new CO (2) – Business review

- Business review should cover the following information –
 - A fair review of its business.
 - A description of its principal risks and uncertainties.
 - Particulars of any important events affecting it which have occurred since the end of the financial year.
 - A discussion on its environmental policies and performance that have a significant impact on the company.
 - An account of its key relationships with employees, customers, suppliers and others that have a significant impact on the company and on which its success depends.

[section 388 and Schedule 5 to new CO]



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Examples of new disclosure requirements under the new CO (3) – Equity-linked agreements

- An agreement that will or may result in the company issuing shares, or an agreement requiring the company to enter into such an agreement (e.g. an option to subscribe for shares), entered into by the company –
 - in a financial year; or
 - in the past but subsisting at the end of the financial year.

[section 6 of Companies (Directors' Report) Regulation
(Cap. 622D)]



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Examples of new disclosure requirements under the new CO (4) – Reasons for resignation

- Disclosure is required if –
 - director resigned or refused to stand for re-election in a financial year; and
 - company received written notice from director specifying that the resignation or refusal is due to reasons relating to the affairs of the company (whether or not other reasons are specified).

[section 8 of Cap. 622D]

- The directors' report for the financial year must contain a summary of the reasons relating to the affairs of the company.
- Not applicable to a company falling within the reporting exemption for the financial year.

More Directors' Duties ??





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