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Directors' duties and liabilities in financial distress during Covid-19

July 2020

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A global perspective

Uncertain times give rise to many questions

The Covid-19 pandemic and the ensuing economic crisis has a significant impact, both financial and otherwise, on companies around the world. Boards are struggling to ensure survival in the short term and preserve cash, whilst planning for the future, in a world full of uncertainties.

Many directors are uncertain about their responsibilities and the liability risks in these circumstances. They are facing questions such as:

- If the company has limited financial means, is it allowed to pay critical suppliers and leave other creditors as yet unpaid? Are there personal liability risks for 'creditor stretching'?
- Can you enter into new contracts if it is increasingly uncertain that the company will be able to meet its obligations?
- Can directors be held liable as 'shadow directors' by influencing the policy of subsidiaries in other jurisdictions?
- What is the 'tipping point' where the board must let creditor interest take precedence over creating and preserving shareholder value?
- What happens to intragroup receivables subordinated in the face of financial difficulties?
- At what stage must the board consult its shareholders in case of financial distress and does it have a duty to file for insolvency protection?
- Do special laws apply in the face of Covid-19 that suspend, mitigate or, to the contrary, aggravate directors' duties and liability risks?



There are more jurisdictions involved than you think

Most directors are generally aware of their duties under the governing laws of the country from which the company is run. However, individuals may also be directors of subsidiaries in other jurisdictions, either personally or indirectly through holding or management entities of which they are directors. And even if they are not, the laws that govern the subsidiaries may classify them as shadow directors of the subsidiary. All this may expose directors to duties and liability risks at local levels.

To complicate matters, liability may not only arise under local company law, but also under tort laws of countries where contracts are entered into that later cannot be performed, causing damages to the company's counterparties. Insolvency proceedings may be opened in yet more jurisdictions where the company or its subsidiaries do business and local insolvency laws may contain specific directors' duties and liability regimes.

Guidance to navigating these risks

We have put together an overview of the main issues facing directors in financially uncertain times in a number of key jurisdictions across the globe. This includes a brief general description of directors' duties and key areas of potential directors' liability in each country, as well as some answers to the questions listed above.

Obviously, the duties and liabilities that may arise will always be dependent on the circumstances. Therefore, this publication should not be used as legal advice when faced with a specific dilemma. However, we hope it may help to alert directors and their in-house advisors to the duties, pitfalls and liability risks that exist in major jurisdictions across the globe.

Hong Kong SAR

No.	Question	Answer
Directors' Duties		
1.	Do directors have to act primarily in the interest of their shareholders or do they have to take in account other stakeholders' interests as well? Does that regime change in case of financial distress?	<p>While a company is solvent and trading normally, directors owe their duties to the company, that is, primarily to its present and future members.</p> <p>However, the obligations of the directors of a company change fundamentally once a company is insolvent. Where a company is insolvent¹ (or nearly insolvent), it is the creditors rather than the members who are likely to suffer as a result of breaches of directors' duties. Accordingly, in such cases, the directors must have primary regard to the interests of the creditors of the company and must exercise their powers with a view to minimising the potential loss to creditors.</p>

¹Whether or not a company is insolvent is a question of fact. Under section 178 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32) (CWUMPO), a company is insolvent if it is proved to the satisfaction of the court that the company is unable to pay its debts (which is broadly speaking a "cash flow" test formulation even though the legislation does not go on to say "as they fall due") and in determining this, the court shall take into account contingent and prospective liabilities of the company (which is more of a "balance sheet" test). In practice, it appears that the court may apply either a "balance sheet" or a "cash flow" test when determining whether or not a company is unable to pay its debts within the meaning of section 178 CWUMPO.



No.	Question	Answer
2.	What are the key areas of potential liability for directors when a company is in financial difficulties?	<p>Despite repeated efforts by the government to implement legislation, Hong Kong SAR does not yet have a ‘wrongful’ or ‘insolvent’ trading regime. There are five main areas of risk for directors under Hong Kong SAR law: (i) fraudulent trading; (ii) misfeasance; (iii) fraud by officers of companies which have gone into liquidation; (iv) offences by officers of companies in liquidation; and (v) disqualification order. We discuss these five main areas of risk below.</p> <p>(i) Fraudulent Trading</p> <p>Fraudulent Trading becomes relevant when a company has gone into insolvent liquidation. Under section 275 CWUMPO, liability for fraudulent trading applies if it can be shown in the course of the winding-up of a company that ‘any business of the company has been carried on with the intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose’. The court may declare that any person who was knowingly party to the carrying-on of the business in this manner (including, for example, the directors, shadow directors or other officeholders, if they were party to the activities) is personally liable to make such contribution (if any) to the company’s assets as the court thinks proper. This will require the court to consider whether the person concerned: (i) participated in the carrying on of the fraudulent business; and (ii) did so knowingly i.e. where they were participating with knowledge that the conduct was intended to defraud. Knowledge will extend to deliberately shutting one’s eyes to the obvious. The person concerned must have been ‘dishonest’. This is tested by reference to the standards of ‘ordinary decent people’.</p> <p>A claim for Fraudulent Trading can be brought by the Official Receiver, a liquidator, or any creditor or contributory of the relevant company.</p> <p>There must be actual intention to defraud creditors or to achieve a particular fraudulent purpose whilst running the business or recklessness as to whether the carrying on of the business would result in the creditors being defrauded. Given this high threshold for liability, it is relatively rare for persons to be found liable for fraudulent trading.</p> <p>Fraudulent trading may apply where the directors of an insolvent company with no prospects of recovery carry on the loss-making business, such as deliberately incurring credit despite knowing it can never be repaid.</p> <p>(ii) Misfeasance</p> <p>There are two aspects to the law of misfeasance in the zone of insolvency. First, as mentioned above, when a company is insolvent, the directors’ duty to the company requires that they consider the interests of creditors in addition to, or to the exclusion of, the interests of shareholders. A director will be liable where a breach of this duty causes loss to the company.</p> <p>Secondly, where a company is in liquidation, section 276 of CWUMPO provides a summary remedy for breach of duty. Under the summary misfeasance remedy, any past or present officer of the company who has misapplied or retained, or become accountable for, any money or other property of the company, or is found guilty of any misfeasance or breach of duty or breach of trust causing loss to the company, will incur liability.</p> <p>Those who may bring this misfeasance action include a liquidator of the company and a creditor of the company. Upon such an application, the court will examine the defendant’s conduct and if thought appropriate, compel them to: (i) repay or restore the money or property or any part of it, with interest at such rate as the court thinks just; or (ii) contribute such sum to the company’s assets by way of compensation in respect of the misapplication, retainer, misfeasance, breach of duty or breach of trust (again, as the court thinks just). So, even where an individual creditor brings a successful action, the remedy will be in favour of the company rather than the individual creditor. In that sense it is a class remedy.</p> <p>The court has a wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.</p>



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		<p>(iii) Fraud by officers of companies which have gone into liquidation</p> <p>An officer (including the directors, managers and secretary of the company) may have criminal liability under section 273 of CWUMPO if:</p> <ul style="list-style-type: none"> i. at any time before the commencement of the liquidation of a company, such officer made any gift, or transfer of or charge on or caused or connived in the levying of any execution against the property of a company; or ii. such officer is said to have concealed or removed any part of the property of the company since, or within two months before, the date of any unsatisfied judgment or order for payment of money obtained against the company, in each case, with the intent to defraud creditors. <p>However, this is a punitive measure, and not a means to compensate the company. In addition, it will be hard to prove intention to defraud creditors, especially to the criminal standard of proof (beyond reasonable doubt).</p> <p>(iv) Offences by officers of companies in liquidation</p> <p>There are also a variety of other criminal offences relating to conduct by officers of companies in liquidation, including fraud in anticipation of winding up, misconduct in the course of winding up, falsification of company books, and false representation to creditors but these are beyond the scope of this questionnaire.</p> <p>(v) Disqualification order</p> <p>Under Hong Kong SAR law, a Court may order that a person who is appointed as a director be disqualified or, if not holding such a position, be restricted from being a director or taking part in the management, formation or promotion of a company, for a period of up to fifteen years. Under section 168C of CWUMPO, “company” is widely defined to include unregistered companies, or registered companies, whether they may be incorporated in or outside of Hong Kong SAR. Disqualification means that the relevant person is barred from being a director of a company or otherwise being concerned in the management, formation or promotion of a company for the relevant period.</p> <p>There are six grounds for disqualification. The three grounds which can apply to a company outside of insolvency are:</p> <ul style="list-style-type: none"> i. persistent breach of requirements under the Companies Ordinance (Cap 622) (the CO) (i.e. for filing of returns and accounts); ii. where a person is convicted of an indictable offence in connection with the promotion, formation, management or liquidation of a company or in connection with the receivership or management of a company’s property or any other indictable offence which involves fraud or dishonesty; and iii. on the grounds of public interest. <p>The three remaining grounds require that the company is insolvent at the time of the relevant conduct or subsequently becomes insolvent. These grounds are:</p> <ul style="list-style-type: none"> iv. where, in the course of a winding up of a company, it appears that a person is guilty of fraudulent trading (of the criminal liability type) or otherwise guilty while being an officer or shadow director of the company of any fraud or breach of duty; v. the conduct of a past or present director or shadow director of an insolvent company, makes them unfit to be concerned in the management of a company; and vi. where a director is found liable for fraudulent trading (even if no application for a disqualification order was made).



No.	Question	Answer
		<p>There is no statutory definition of ‘unfitness’. In deciding whether a person is unfit to be concerned in the management of a company, the court will consider the factors listed in the Fifteenth Schedule of the CWUMPO. This non-exhaustive list includes a full range of the director’s conduct, including the extent of the director’s responsibility for: (i) the causes of the company (or any overseas company) becoming insolvent, and (ii) the company entering into any transaction or giving any unfair preference which is liable to be set aside.</p> <p>The court will also look at any matters or acts relevant to the conduct of the affairs of the company and its insolvency, such as: (i) the statutory requirements for keeping proper books of account, (ii) delivering the company’s property to the liquidator, and (iii) compiling the statement of affairs.</p> <p>Disqualification orders are enforced primarily by the government regulators (particularly the Official Receiver’s Office), however in some cases, it is possible that action for disqualification can be brought by the Financial Secretary, a liquidator or any past or present member or creditor of the relevant company.</p> <p>Under Hong Kong SAR insolvency law, there is no provision for automatic disqualification. It should be noted that where a person is found liable for fraudulent trading, the court has a discretion to make a disqualification order against such person irrespective of whether an application for a disqualification order is made.</p>
3.	Does liability rest only with formally appointed directors, or also with (other) officers or de facto directors? If so, what are the standards to qualify as such?	<p>Hong Kong SAR law recognises that a company’s affairs during the twilight period may not only be influenced by those formally appointed as directors. The CO defines a director as any person who occupies the position of director, by whatever name called. This covers more than just formally appointed (de jure) directors and extends to a person who acts as a director (a de facto director) or a person in accordance with whose directions or instructions the directors of a company are accustomed to act (a shadow director). If such people have caused loss to the company and its creditors during this time, they may also be found personally liable for such loss. As regards the main liability risks discussed above, the persons who can be held liable are, in summary, as follows:</p> <ul style="list-style-type: none"> (i) Fraudulent Trading: any person who was knowingly a party to the carrying on of the business for a fraudulent purpose (including persons dealing with the company who receive property with knowledge of the fraud); (ii) The duty to consider the interests of creditors applies to de facto and de jure directors. The misfeasance remedy is available against any past or present officer, provisional liquidator or liquidator, and receiver or manager of the property of the company; and any person involved in the formation, promotion or management of the company; (iii) Fraud by officers of companies which have gone into liquidation: in addition to directors, officers (i.e. a manager or a company secretary) may also be liable for this offence; (iv) Offences by officers of companies in liquidation: any officer or shadow director of the company at the time of the offence may be liable; (v) Disqualification order: any person occupying the position of director, by whatever name called (including de facto directors and shadow directors).



No.	Question	Answer
4.	What are the standards for directors' liability for the company having entered into contracts that the company can later not perform ('wrongful trading')?	<p>In the absence of wrongful or insolvent trading legislation, it is not necessary for directors to analyse, when incurring credit, whether the company is insolvent and has any prospect of avoiding insolvent liquidation. However, even in the absence of insolvent trading legislation, the directors must have regard to the interests of creditors if the company is or may become insolvent.</p> <p>Conceivably the incurring of further credit which cannot be satisfied in full when due, and which results in a reduction in creditors' recoveries, may result in a claim by a liquidator for damages for breach of duty.</p> <p>A reckless incurring of credit by directors during the twilight period, without proper consideration of the prospects of repayment in full, may lead to disqualification proceedings. In order to be free of the risk of personal liability or vulnerability to disqualification proceedings, a director should not incur credit during the twilight period unless, following proper consideration, he is satisfied that there is a reasonable prospect that the credit can be discharged in full when due.</p> <p>Provided that a director exercises reasonable care, skill and diligence and acts honestly and in good faith, however, for as long as there is no insolvent trading legislation in Hong Kong SAR it is unlikely that the incurring of credit during the twilight period will result in the director being personally liable or at risk of disqualification.</p>
5.	What are the liability risks in the case of 'creditor stretching'?	<p>Absent particular facts (for example, where a director fraudulently or negligently misstates the company's financial position), managing a company's cashflow ('creditor stretching') in times of financial distress is a relatively normal way for a company to seek to find the time to restructure. Deliberately paying some creditors (particularly connected creditors) ahead of others may render the directors vulnerable to attack.</p>
6.	What are the liability risks in case of selective payments to some but not all creditors in case of liquidity issues? Is there a stage at which directors must treat all creditors equally?	<p>Given the lack of wrongful / insolvent trading legislation in Hong Kong SAR, there is relatively low risk for the directors when managing the company's cash flow and 'ransom' payments to key creditors may be justifiable although equal treatment of the creditors of the same rank is usually the appropriate approach.</p> <p>Paying one creditor when knowing that the company is unable to satisfy all its debts at that time will not be considered fraudulent if the director believes that the company will be able to pay its debts in the future.</p> <p>However, to the extent that such selective payments constitute an unfair preference, the directors responsible for causing such unfair preference may be personally liable.</p>
7.	Is there a distinction in this regard between preferential treatment of related entities and the treatment of other creditors?	<p>As a general point, many legal rules make it inadvisable to pay connected persons in priority to others. For example, under Hong Kong SAR law, if a transaction is challenged as an unfair preference, the court must not make an order against a person in respect of unfair preference unless the company who gave the unfair preference had a desire to give the preference to the counterparty. However, such desire is presumed if the counterparty is a connected person to the company.</p>



No.	Question	Answer
8.	Is there an obligation in case of financial difficulties to convene a shareholders' meeting and, if so, at what stage of financial difficulties?	No, Hong Kong SAR law does not impose an obligation in case of financial difficulties to convene a shareholders meeting.
9.	Is there an obligation at some stage to file for bankruptcy or other statutory insolvency protection regimes?	Hong Kong SAR insolvency law does not have an express requirement to file at a particular time.
10.	Are there special liability risks in respect of certain debts, such as tax debts, social security payments, and pension contributions?	Under section 23 of the Employment Ordinance (Cap 57) (EO), wages must be paid as soon as practicable but in any case not later than 7 days after the last day of a wage period. Wilful contravention of this section without reasonable excuse is a criminal offence. There is precedent for the courts holding that the financial difficulties of a company do not amount to a reasonable excuse. In addition, under section 31 of the EO, an employer must not enter into a new or continue a contract of employment unless they believe on reasonable grounds that they will be able to pay all wages due under the contract of employment as they become due (the contravention of which is also a criminal offence).
11.	Are the liability risks of the directors collective (i.e. the whole board is responsible/liable) or individual? On what grounds can a director exculpate themselves from other directors' acts or omissions?	Directors in Hong Kong SAR owe their duties individually and collectively (i.e. their duties of care, skill and diligence). This means that in addition to their individual duties, the directors have collective responsibility for the decisions they make. As stated above, the minimum standard required of a director is that of a reasonably diligent person having the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as that director (i.e. an objective test). However, the actual standard by which a particular director is judged will be higher if that director's general knowledge, skill and experience are, in fact, greater (i.e. a subjective test). In practice, boards will try to reach a unanimous decision on major issues such as whether to file for insolvency. Where, say, one director feels strongly that the company should file and the rest of the board consider it is reasonable to continue trading, that director may feel compelled to resign as a director. There is a general defence under section 903 of the CO to a breach of duty claim where a director has acted honestly and reasonably and, in the circumstances, the court concludes that they ought fairly to be excused.
12.	Are there specific actions against directors under bankruptcy law?	Please see risks discussed above. It is worth noting in passing that in Hong Kong SAR law 'bankruptcy' is a term applied to the insolvency of individuals. 'Insolvency' is the term used for corporates.



No.	Question	Answer
13.	Are there specific duties of (or consequences for) shareholders or other group companies at some stage of the financial difficulties, such as an automatic subordination or conversion into equity of debt to parent companies?	<p>Hong Kong SAR law does not have a general law of shareholder duties nor do we have thin capitalisation rules or a law of equitable subordination of shareholder loans. In an insolvency, for example, intercompany loans are not subordinated or converted into equity. There is a law of ‘piercing the corporate veil’ such that a parent company, say, may be made liable for the debts of its subsidiary but its scope is narrow and often involves other concepts such as fraud, agency, or sham transactions.</p> <p>A few specific points to note in the context of group companies:</p> <ul style="list-style-type: none"> (i) If a director is on the board of a number of companies in a group, they must wear their hat as director of each company in turn, individually, and consider the financial position of that company alone when making decisions for each company. (ii) There is also a positive obligation for directors to avoid potential conflicts of interest. For example, a director should ensure that the financial difficulties have not caused a potential conflict of interest with their position as director of other companies within a group. Where there is a potential conflict of interest, consideration should be given to whether the relevant director might resign from one or more of their positions or recuse themselves and take no part in the board discussions or decision-making at one company or the other. (iii) A common director of two companies (for example, a director of a parent and its subsidiary) with confidential information at parent level which concerns the financial position of the subsidiary may be placed in an awkward position (i.e. there may be a conflict of interest). (iv) Where a parent company or the directors of such a parent operate a “hands on” approach to running the group and interfere persistently in the management of the subsidiary companies, the parent company (or, exceptionally, its directors) may be a shadow or <i>de facto</i> director of the subsidiary and accordingly the attendant duties and potential liabilities set out in the sections above will attach to them.
14.	Is there special legislation mitigating the liability risks of directors specifically in view of the Covid-19 crisis?	There is no special legislation in Hong Kong SAR mitigating the liability risks of directors specifically in view of the Covid-19 crisis.



Contacts



Ian Chapman
Partner
Tel +852 2974 7019
ian.chapman@allenoverly.com



Fai Hung-Cheung
Partner
Tel +852 2974 7207
fai.hung.cheung@allenoverly.com



Richard Woodworth
Partner
Tel +852 2974 7208
richard.woodworth@allenoverly.com



Viola Jing
Of Counsel
Tel +852 2974 6951
viola.jing@allenoverly.com



John Deng
Associate
Tel +852 2974 7291
john.deng@allenoverly.com



For more information, please contact:

London

Allen & Overy LLP
One Bishops Square
London
E1 6AD
United Kingdom

Tel +44 20 3088 0000
Fax +44 20 3088 0088

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