

## Disqualification

### ¶20-900 Disqualification generally

A company's articles normally provide that a director's office must be vacated if he:

- ceases to be a director because of failure to fulfill a share qualification (see ¶20-310);
- becomes bankrupt or makes any arrangement or composition with his/her creditors generally;
- is prohibited from being a director by virtue of a disqualification order made under the Ordinance (see ¶20-910ff.);
- becomes of unsound mind;
- gives notice of his/her resignation (see ¶20-860); or
- has been absent from meetings of the directors for more than six months without the permission of the directors (sec 27, Sch 1 of the *Companies (Model Articles) Notice*).

### ¶20-910 Disqualification orders

Part IVA of the *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32) provides for the disqualification of a person from acting as a director or other officer of a company if that person:

- has been convicted of an indictable offence (see ¶20-920 and sec 168E);
- has persistently breached the requirements to file returns, accounts, etc (see ¶20-930 and sec 168F);
- is guilty of fraud in winding up (see ¶20-940 and sec 168G);
- in the public interest, if the person is unfit to be concerned in the management of a company (see ¶20-950, and secs 168H–168K, Cap 32); or
- upon a declaration of fraudulent trading (see ¶20-960, and sec 168L, Cap 32).

Disqualification orders are made by a court and prohibit a person from acting, without leave of the court:

- as a director of a company;
- as a liquidator of a company;

- as a receiver or manager of a company's property; or
- from being in any way concerned or involved in the promotion, formation or management of a company (sec 168D(1), Cap 32).

Application for a disqualification order may be made by the Official Receiver of a company, the Financial Secretary, or by the liquidator or any past or present member or creditor of a company in relation to which the relevant person has committed an offence or other default. Where a person intends to apply for a disqualification order he or she must give at least ten days' notice of that intention to the person against whom the order is to be sought (sec 168P(1), Cap 32). Failure to give such notice may render any subsequent proceedings invalid (*Re Jaymar Management Ltd* (1990) BCC 303, ChD).

The Official Receiver is empowered to conduct a public examination in court of the promoters or directors of a company which has been wound up by the court. The person ordered to be examined must be furnished with a copy of the Official Receiver's report stating that in his opinion a *prima facie* case exists against that person that would render him liable to a disqualification order. The person may employ at his own cost, a solicitor with or without counsel, who can put to him such questions as the court deem just to allow him to explain or qualify any answers given by him. The powers of the Official Receiver to order public examination of promoters and directors can be found in sec 168I of Cap 32.

The maximum disqualification period specified under a disqualification order may be as long as 15 years, depending upon the circumstances. Where a person is subject to more than one disqualification order, the orders run concurrently (sec 168D(3)). Note that the disqualification provisions contained in the Hong Kong *Companies Ordinance* are substantially similar to the UK *Company Directors Disqualification Act 1986*.

In *Official Receiver v Chan Hing To* [2008] HKCU 1125, CA, the disqualified director sought to have the term of his disqualification reduced. Amongst the complaints made against him, giving rise to the order of disqualification, were those that he had failed to keep books and accounts, had not co-operated with the Official Receiver, had not complied with statutory filing requirements and had misused a bank account belonging to the company. The principles, the court adopted in reducing the term of disqualification from four years to three-and-a-half years, included:

- the rationale behind the disqualification;
- the delay in application for disqualification;

- the need for a flexible common sense and practical approach to case management, the operation of the statutory period of disqualification;
- relevant personal factors such as the general ability of the director or whether he is likely to offend again; and
- the conduct of the director in relation to other companies (for this factor the weight to be attached to the conduct differs from that relevant to the company in liquidation).

In summing up the relevant factors, the court referred to the fact that the director's misconduct "not only affected the internal management of the companies but also prejudiced creditors who were unable to recover their money from the companies".

Section 214(1) of the *Securities and Futures Ordinance* sets out the circumstances in which the court will make various orders against the company or the directors. The section was considered in *Securities and Futures Commission v Fung Chiu* [2008] HCMP 2524/2006, where the Commission sought appropriate orders against the five directors of a company which was listed, until removed, on the Growth Enterprise Market (GEM). The order being sought was one to prevent the directors, without leave of the court, being or continuing to be directors, liquidators, receivers or managers of a company, or in any way directly or indirectly involved with a company for up to 15 years. One director had consented to the order being made against him by summary proceedings. The procedure was that referred to as the "Carecraft" procedure, following the decision in *Re Carecraft Construction Co Ltd* [1994] 1 WLR 172. This case had been followed in *Re Riverhill Holdings Ltd* [2007] 4 HKLRD 46.

In this case, the director had agreed to a disqualification period of six years. However, in considering the facts, and despite the SFC's case being based on gross negligence, a period of disqualification of five years was apt. This was because there had been no allegation of fraud or dishonesty against the director, and there had been no suggestion that he had made any personal gain from loans advanced by the company.

*Kwan J.* (as she then was) pointed out two important factors relevant to exercise of the jurisdiction to make disqualification orders:

"firstly, protection of the public against the future conduct of persons whose past records as directors of listed companies have shown them to be a danger to those who have dealt with the company, including creditors, shareholders, investors and consumers; and, secondly,

general deterrence in that the sentence must reflect the gravity of the conduct complained of so that members of the business community are given a clear message that if they breach the trust reposed in them they will receive proper punishment: [2009] 2 HKC 19, 23 at para 12." (*Securities and Futures Commission v Fung Chiu* [2008] HCMP 2524 of 2006, para 55)

The question of deterrence rather than punishment of a criminal nature was referred to by Yeun J. in *The Official Receiver v Chan Min Simon* [2001] 9 HKJR 23 as:

"7. It is now generally accepted as a matter of substantive law that disqualification is not a "punishment", and that even though its purpose is "to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies showed them to be a danger to creditors and others" (*Secretary of State for Trade and Industry v Griffiths* [1998] BCC 836, 843F), disqualification proceedings are civil proceedings, applying the civil standard of proof on the balance of probabilities (*Re Verby Print for Advertising Ltd, Fine & Anor v Secretary of State for Trade and Industry* [1998] 2 BCLC 23, 30-2) and adopting civil procedure."

This view was in keeping with the decision in *Carecraft* which provided that where the parties had agreed on certain facts, which were not opposed, the disqualification of the director could be dealt with summarily.

## ¶20-920 Conviction of indictable offence

A court has the discretionary power to make a disqualification order against a person convicted of:

- an indictable offence in connection with the promotion, formation, management or liquidation of a company;
- an indictable offence in connection with the receivership or management of a company's property; or
- any other indictable offence which involves a finding of fraud or dishonesty (sec 168E(1), *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32)).

An indictable offence "in connection with the management of a company" means that the offence "must have some relevant factual

connection with the management of company” (*R v Goodman* [1992] BCC 625 per *Staughton* L.J. at para 627E).

The disqualification order on conviction of an indictable offence may be made by the High Court or any other court before which the person is convicted. Persons eligible to apply for the disqualification order are: the Official Receiver; the Financial Secretary; or the liquidator, a past or present member or a creditor of the company affected by the disqualified person's actions (sec 168P(2), Cap 32). Note, however, that the order may also be made if the court thinks fits, whether or not any person has made an application (sec 168P(4), Cap 32).

The maximum disqualification period is:

- 15 years — if order made by High Court judge;
- 10 years — if order made by District Court judge;
- 5 years — if order made by magistrate (sec 168E(3), Cap 32).

Where a disqualification order has been made by a magistrate, but the facts appear to warrant a longer period of disqualification, an application may be made to the High Court for a longer disqualification period (sec 168E(4), Cap 32).

## ¶20-930 Persistent breach of under Cap 32

A court, including a magistrate, has the discretionary power to make a disqualification order against a person who has persistently defaulted in his/her obligations under the *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32) to file returns, accounts or other documents, or to deliver notices to the Registrar (sec 168F(1), Cap 32). A person is regarded as having been persistently in default if he/she has been guilty of three or more defaults during the preceding five years (sec 168F(2), Cap 32).

An application for a disqualification order for persistent breach of the Ordinance may be made by the Registrar, the Official Receiver, the Financial Secretary, or by the liquidator or any past or present member or creditor of a company in relation to which the person has been in default (sec 168P(2), Cap 32). Ten days' notice of the intention to apply for a disqualification order must be given to the person against whom the order is sought (unless the application is made in the course of prosecution for an offence). The affected person has a right to appear, give evidence or call witnesses on the hearing of the application (sec 168P(1)).

The maximum disqualification period for persistent breaches of the *Companies Ordinance* is five years (sec 168F(5), Cap 32).

### ¶20-940 Fraud in winding up under Cap 32

A court has the discretionary power to make a disqualification order against a person if, in the course of the winding up of a company, it appears that the person has been guilty of:

- fraudulent trading (for which he/she is liable under sec 275 of the *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32)); or
- any fraud in relation to the company, or any breach of his/her duty as an officer, liquidator, receiver or manager of the company (sec 168G(1), Cap 32).

A disqualification order for fraud may be issued to a shadow director as well as any director or other officer.

Application for a disqualification order for fraud in winding up may be made by the Registrar, the Official Receiver, the Financial Secretary, or by the liquidator or any past or present member or creditor of a company in relation to which the person has committed an offence (sec 168P(2), Cap 32).

The maximum disqualification period is 15 years (sec 168G(2), Cap 32).

### ¶20-950 Unfit directors of insolvent companies

It is *mandatory* for a court to make a disqualification order against a past or present director or shadow director of a company which has become insolvent if it is satisfied that the person's conduct as a director of that company makes him/her unfit to be concerned in the management of a company (sec 168H(1), *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32)).

Disqualification orders under sec 168H of Cap 32 can only be made against a present or past director of a company which has *become insolvent*. A company becomes insolvent for the purposes of sec 168H of Cap 32, if it goes into liquidation when its assets are insufficient to pay its debts and liabilities and the expenses of winding up; or if a receiver is appointed (sec 168H(2)). References to a person's conduct as a director include, where a company has become insolvent, the person's conduct in connection with or arising out of the insolvency.

The minimum period of disqualification under sec 168H of Cap 32, for a person unfit to be involved in the management of a company,

is one year. The maximum period is 15 years (sec 168H(4) of Cap 32). The UK Court of Appeal has stated, in relation to equivalent UK legislation, that the top bracket of disqualification for periods over ten years should be reserved for particularly serious cases: for instance, where a person is disqualified for a second time. The minimum period of disqualification up to five years should be applied where the case is not very serious and the middle bracket of six to ten years should be applied to serious cases which do not merit the top bracket (*Re Sevenoaks Stationers (Retail) Ltd* [1990] BCC 765).

### Disqualification in public interest

The Financial Secretary, or the Official Receiver in the case of a company that is being wound up, may apply for a disqualification order to be made under sec 168H of Cap 32 if it appears that it would be in the public interest (sec 168I(1), Cap 32). Such an application must be made within four years of the commencement of the winding up of the relevant company or, in the case of a receivership, within four years of the day on which the receiver vacates his/her office.

A liquidator or receiver of a company who believes that a director or shadow director of the company is unfit to be involved in management must report the matter to the Official Receiver, who may report the matter to the Financial Secretary (in the case of companies that are not being wound up this is mandatory) (sec 168I(3), Cap 32).

The Official Receiver or the Financial Secretary may request a liquidator or receiver who makes a report against a director to supply further information or documentation to enable them to determine whether to apply for a disqualification order in the relevant case.

### Disqualification after investigation

Under sec 168J of *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32), the Financial Secretary may apply for a disqualification order to be made against a past or present director or shadow director if it appears, on the basis of:

- an inspector's report (made under secs 855 and 856),
- documents produced by the company for inspection (under sec 868), or
- information or documents obtained during the entry and search of premises (under sec 877),

that it would be expedient in the public interest.

The court may make the disqualification order if it is satisfied that the director's conduct in relation to the company makes him/her unfit to be concerned in the management of the company.

The maximum period for disqualification under sec 168J is 15 years (sec 168J(3)).

*Re Samuel Sherman plc* [1991] BCC 699 is a UK case in which a former chairman of a public company was disqualified from being a director for five years on the ground of unfitness following an investigation under the *Companies Act 1985*.

### **Matters for determining the unfitness of directors**

A court which has the task of determining whether a person's conduct as a director of a company makes him/her unfit to be concerned in the management of a company must consider the following matters under the *Companies Ordinance* (Cap 622):

... in all cases

- (1) any misfeasance, breach of fiduciary duty or breach of any other duties in relation to the company;
- (2) any misapplication or retention of money or property of the company, or any conduct giving rise to an obligation to account for money or property of the company;
- (3) the extent of the director's responsibility for any failure by the company to:
  - register charges created by the company as required under sec 334;
  - keep a register of members as required under secs 627 to 628;
  - keep an index of members as required under sec 630;
  - make an annual return as required under secs 662 and 664, and Sch 6;
  - keep minute books at its registered office or to notify the Registrar of the place where minute books are kept, or of any change of place as required under sec 619;
  - keep proper books of account as required under secs 373 and 374;
  - keep a register of directors and secretaries as required under sec 641; and



- keep the register of directors and secretaries at its registered office or to notify the Registrar of the place where the register is kept or of any change of place as required under sec 641.
- (4) the extent of the director's responsibility for a failure by the directors to:
  - lay before the company at its annual general meeting a profit and loss or income and expenditure account and balance sheet as required under secs 429, 431 and 610; and
  - approve and sign every balance sheet of the company as required under sec 387.

... where company has become insolvent

- (1) the extent of the director's responsibility for causing the company to become insolvent;
- (2) the extent of the director's responsibility for the company's failure to supply goods or services which have been paid for;
- (3) the extent of the director's responsibility for entering a transaction or giving any preference which is liable to be set aside under sec 182 or 266 of Cap 32;
- (4) the extent of the director's responsibility for the directors' failure to fulfil their duties under sec 241 of Cap 32 in relation to a creditors' meeting to consider a resolution for voluntary winding up;
- (5) any failure by the director to comply with his/her obligations in relation to:
  - a statement of the company's affairs to be submitted to the official receiver, imposed under sec 190 of Cap 32;
  - the delivery of property to a liquidator, imposed under sec 211 of Cap 32;
  - a voluntary winding up due to inability to continue business, imposed under sec 228A of Cap 32;
  - a creditors' meeting to consider a resolution for voluntary winding up, imposed by sec 241 of Cap 32;
  - the keeping of proper accounts, imposed by sec 274 of Cap 32;
  - the appointment of a receiver or manager, imposed by sec 300A of Cap 32.

These matters are prescribed under Part II of Sch 15 (see sec 168K(1)(b), Cap 32).

Note that a director who is also a shareholder may not be able to avoid disqualification as an unfit director by showing that he/she had delegated the running of the company which became insolvent to another director (*Re Burnham Marketing Services Ltd & Anor* [1993] BCC 518).

### UK case law on “unfitness” of directors

A body of case law has developed in the UK regarding the circumstances in which the courts will grant a disqualification order on the grounds of unfitness.

The UK courts have stressed that they consider protection of the public, rather than punishment of the individual, to be the primary purpose for making an order (*Re Lo-Line Electric Motors Ltd* [1988] 4 BCC 415). The courts are careful, however, not to stifle enterprise (*Re Douglas Construction Services Ltd* [1988] 4 BCC 553). Commercial mismanagement alone, particularly when based on professional advice, may not justify a disqualification (*Re McNulty's Interchange Ltd & Anor* [1988] 4 BCC 533). On the other hand, gross incompetence, even without any breach of commercial reality, has caused a person to be disqualified (*Re Churchill Hotel (Plymouth) Ltd* (1988) 4 BCC 112).

In *Re Bath Glass Ltd* (1988) 4 BCC 130, Peter Gibson J. stated:

“To reach a finding of unfitness the court must be satisfied that the director has been guilty of a serious failure or serious failures, whether deliberately or through incompetence, to perform those duties of directors which are attendant on the privilege of trading through companies with limited liability. Any misconduct of the respondent qua director may be relevant, even if it does not fall within a specific section of the *Companies Act* or the *Insolvency Act*.”

In *Re ECM (Europe) Electronics Ltd* [1991] BCC 268 the court refused to make a disqualification order in relation to a person against whom a list of complaints had been made because the person had not been incompetent, negligent or dishonest. In the court's view, the failure to maintain standards expected from a company director was not so blameworthy as to be stigmatised as a breach of commercial morality.

Behaviour which has led the courts to make a disqualification order on the grounds of unfitness includes:

- using sums owed to the Crown as working capital for an insolvent company (see *Re Stanford Services Ltd* [1987] 3 BCC 326; *Re Bath Glass Ltd*; and *Re Lo-Line Electric Motors Ltd*); and

- failure to keep proper books of account and submit annual returns and accounts (*Re Western Welsh International System Buildings Ltd* (1988) 4 BCC 449).

In *Re Cladrose Ltd* [1990] BCC 11 a non-accountant director was not disqualified as unfit when he/she relied on his/her co-director, who was an accountant, to ensure that the accounts would be produced and annual returns filed. The director who was a chartered accountant, and who admitted that it was reasonable for his/her co-director to rely on him/her, was disqualified for the minimum period.

## ¶20-960 Fraudulent trading

A court has the discretionary power to make a disqualification order against a person who is guilty of fraudulent trading and has been declared liable for debts or liabilities of a company under sec 168L(1) of Cap 32. The order may be made whether or not an aggrieved person applies for it.

The maximum disqualification period for an order made in these circumstances is 15 years (sec 168L(2)).

## ¶20-970 Procedural matters

The *Companies (Disqualification of Directors) Proceedings Rules* provide the following procedural matters in respect of the disqualification of directors.

- *Application by summons.* An application for a disqualification order must be made to the court by originating summons according to the *Rules of the Supreme Court* (r 3).
- *Filing of evidence.* Evidence in support of the application must be filed in court in the form of affidavits (or written reports in the case of evidence presented by the Official Receiver). Copies of the evidence must be served, together with the summons, to the person against whom the order is to be made (the relevant person) (r 4). If a disqualification order is applied for on the basis that the person is unfit to be involved in management of a company the evidence must include a statement of the matters giving rise to that allegation.
- *Service of summons.* The summons must be sent by post to the relevant person to his or her last known address accompanied by a form for acknowledgment of service which the relevant person is required to return to the court within 14 days from

the date of service (r 6(1), (3)). (The date of service is deemed to be the 7th day after the date on which the summons was posted.)

- *Contest of application, adducement of mitigating factors.* A person against whom an application for a disqualification order has been made may contest the application on the grounds that:
  - he was not a director, shadow director, officer, liquidator or receiver or manager of property at the time in question;
  - his conduct as a director, shadow director, officer, liquidator or receiver was not as alleged; or
  - that his conduct does not make him unfit to be concerned in the management of a company.
- Alternatively, the relevant person may adduce mitigating factor to justify a shorter period of disqualification.
- The relevant person should indicate in the acknowledgment of service the grounds on which the application will be contested or the fact that he or she intends to adduce mitigating factors (r 6(4)). Evidence supporting the relevant person's opposition to an application must be filed within 28 days from the date of service of the summons (r 7). A copy must be sent to the person applying for the order.
- *Hearing and determination of case.* The hearing of the application will be no earlier than eight weeks after the date of issue of the summons. The court may determine or adjourn the case (r 8). Note that a disqualification order may be made whether or not the relevant person appears and whether or not he or she had completed the acknowledgment of service of summons (r 9).
- *Effective date of order.* A disqualification order takes effect on the 21st day after it is made (r 10).

## ¶20-980 Contravention of order

### Penalties

A person who contravenes a disqualification order is guilty of an offence for which the penalty on indictment is imprisonment for two years and a fine of HK\$100,000. For a summary offence the penalty is imprisonment for up to six months and a fine of HK\$25,000 (sec 168M and Sch 12, *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32)).

If the offence is committed by a body corporate with the consent of, or due to negligence by, any of its directors, managers, secretaries or other officers, the relevant person as well as the body corporate will be guilty of the offence and liable to be penalised accordingly (sec 168N, Cap 32).

### Personal liability

A person is personally responsible for the debts of a company if he/she becomes involved in the management of a company:

- in contravention of a disqualification order; or
- in contravention of his or her disqualification as an undischarged bankrupt under sec 156 (see sec 168O(1)(a), Cap 32).

The liability of a disqualified person or an undischarged bankrupt is limited to the debts and other liabilities of the company which are incurred while he/she is involved in the management of the company.

A person involved in the management of a company who acts or is willing to act, without the leave of the court, on the instructions of a disqualified person or an undischarged bankrupt is also personally liable for the company's debts (sec 168O(1)(b), Cap 32). Such liability is limited to the debts and liabilities incurred at the time when he/she acted or was willing to act on the disqualified person's instructions.

If two or more people are liable for a company's debts under sec 168O of Cap 32 then their liability is joint and several (sec 168O(2), Cap 32).

### ¶20-990 Register of orders

The Registrar maintains a Register of Disqualification Orders and of cases in which leave has been granted to a person to be involved in an activity (promotion, directorship, liquidation) which would otherwise be prohibited by virtue of a disqualification order made under Part IVA of the *Companies (Winding-Up and Miscellaneous Provisions) Ordinance* (Cap 32).

Information on this register contains the particulars of people or companies disqualified. These include the English and Chinese name, address, Hong Kong Identity Card or passport number and issuing country, and company number (in the case of a corporate body). The information also includes details of the court making the order, the date and reference of the order and the details of the disqualification.

To facilitate the maintenance of the register, officers of courts which make disqualification orders are required to furnish the following particulars to the Registrar: