

October 2019 Legal and Regulatory Update

Top stories

New SFC cases on director duties in acquisitions/disposals

Two new cases illustrated “recurring types of misconduct” referred in SFC’s recent [Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals](#). (Background: our [July 19 legal update](#))

(i) SFC obtained disqualification orders (s. 214, *Securities and Futures Ordinance*) in the Court of First Instance against former chairman/executive director (“ED”), and three former EDs, of Inno-Tech Holdings Limited (GEM-listed; the “Company”). They were disqualified from being a director or taking part in the management of any corporation in Hong Kong, without leave of the Court, for a period of **three years**.

(Click: [Press release](#); detailed facts: [extracts from SFC’s filed petition](#))

All admitted that they were in breach of their directors’ duty to **exercise due and reasonable skill, care and diligence** by failing to, (i) carry out **adequate due diligence** prior to acquisitions of three Mainland hotels, and a gold mine in 2007- 2009; (ii) **negotiate the consideration**.

All the assets were subsequently disposed at a loss to the Company.

There was **no dishonesty, bad faith, illicit gain or conflict of interest** involved.

What you should know:

Failure to carry out adequate due diligence

- **Independent valuation, directors’ independent judgement**

Hotel acquisitions:

- **Delegated** acquisition decision, **without supervision**, to staff team in China
- **Cannot produce evidence** as to how investment decision was made; adequate due diligence
- **Valuation report** for one property only; (all) did not consider liability of companies holding the properties and future profitability of hotels

Gold mine acquisition:

- Directors simply **relied on valuation without performing due diligence**
- **No evidence** as to site visits, meetings with experts as stated in corporate announcements

- **Failure to assess appropriateness of investing in gold mine**
 - **The board had no skills in this area**
- **Impact on financial position**
 - Gold mine acquisition: did not consider substantial funds needed for **capital investment** to sustain the business
- **Failure to negotiate consideration**
 - **Announced** that there were **arm's length negotiations**
 - But **no evidence** as to any negotiation for all acquisitions

(ii) **SFC has commenced legal proceedings** in the Court of First Instance to seek **disqualification and compensation orders** (under s, 214) against the chairman/ED of Perfect Optronics Limited (GEM listed; the “Company”), and the rest of its directors (including independent directors) for alleged breach of fiduciary duties. (Click: [Press release](#))

This case concerns “**profit guarantees**”. The chairman sold a group of companies to the Company, and provided a **guarantee of minimum profit**. Compensation is payable if target not met.

A few days prior to the expiry of the guarantee period, the Company sold part of the acquired companies. The gain boosted the acquired companies’ profit. Compensation payable by the chairman was significantly reduced (\$251.9 million).

What you should know:

- Alleged breach by chairman
 - Material interest in the transaction, given significant reduction in compensation payable
 - But failed to (i) avoid involvement in negotiations, (ii) disclose to the other directors and (iii) abstain from voting
- Alleged breach of the other directors
 - Failed to properly investigate the terms of the transaction
 - And/or balance the pros and cons of postponing the transaction till after the guarantee period

LESSONS FROM BOTH CASES

What you should watch out for/do:

- **Sharpened focus on “individual accountability”**: investigation not only looked into where the transaction went wrong, but also **how/why it was approved by the board**
- **Directors’ duties of care, skills, and diligence** in approving transactions — high standards expected
- **Board process in approving transactions** — should seriously consider engaging a valuer
- **Internal controls** — embed principles of the **SFC Statement** (e.g. the need to engage a valuer) in **your company’s policies and procedures**.

Other Stories

Regulators

SFC has commenced proceedings in the Market Misconduct Tribunal (“MMT”) against China Medical & Healthcare Group Limited, and **6 directors** at the relevant time (**including independent directors**), for failing to disclose information regarding significant gains in securities trading as soon as reasonably practicable in 2014. (Click: [Press release](#); [MMT notice](#))

Key issue is such gains in securities trading should have been apparent from **internal management accounts** made available to all directors.

What you should know/watch out for:

- **Nature: delay in disclosure — securities trading gains**
- **Internal management accounts** relevant: such gains should have been apparent
- **Securities trading gains: specific information** regarding the company; **price sensitive** and **not generally known to the public** at the material time
- (2014) chronology:
 - Securities portfolio included shares in a listed company (“investee”; now known as Alibaba Pictures Group)
 - **(March)**: Investee share price rose significantly following announcement of investment by Alibaba Group
 - **(March)**
 - (i) Company then disposed of shares; significant profit (\$360m)

- (ii) Cumulative profit for first nine months: \$894m (2013: loss of \$33m)
 - **(April):** directors received **internal financial report, reflecting such gains**
 - **(Sept):** finally **issued profit alert**; share price rose over 12%
- Those directors, being **officers**, are alleged to be **in breach** for reckless or negligent conduct causing alleged breach by company

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