THE BUCK STOPS WHERE? THE HIDDEN RISKS FOR DIRECTORS

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Whilst a company and its directors remain separate legal entities, the winding-up of the business does not always result in a risk-free outcome for its board members. In fact, it can often signal the beginning of far more turbulent times for the directors and their professional futures. So, with global insolvencies on a sharp rise, it's more important than ever for directors to grasp the legal issues they could face, personally and professionally.

Directors can face legal action by way of Disqualification of Directors orders under sections 168D and 168H of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), or CWUMPO. If granted, they would be barred from acting as a director of any company, or be concerned with (or take part in) the promotion, formation or management of a company for up to 15 years.

Is the failure by directors to ensure payment of wages to employees sufficient to attract a disqualification order? This was the question in the decision of the Official Receiver v Samuel Ajmal Victor , where the official receiver applied for a disqualification order against one of the directors. The company in question developed an electronic transaction processing platform and its operating expenses were sustained by shareholders' fund injections and allotment of shares, including HK$5M by shareholder allotment injection in October 2012. Although the platform had been developed and looked promising, it proved to be too advanced for the market at the time and, by early 2013, the company was unable to generate any revenues.

The director made efforts to seek outside investments and, in May that year, an interested outside investor proposed to acquire the platform for US$500,000. The company had immediate liabilities, including

employee wages, which it was unable to meet and, as such, negotiations continued regarding the method of payment and how much of those liabilities would be. Meetings were held with employees to explain the deal which could save the company and ensure payments of salary. The director asked if employees would agree to continue working with delayed payment of wages and, whilst some disagreed and left with their full wages paid, others agreed and stayed, expressing their faith in the platform and the deal, defined with a deferral agreement.

The outsider paid the consideration US$500,000 as an upfront loan, secured by the director's personal guarantee and charged against the platform, for paying some creditors, employees and operational costs. A term sheet was signed in September 2013, with the outsider acknowledging the creditors with whom to negotiate the repayment schemes with.

However, further negotiations on the deal failed. Staff who agreed to stay, having not been paid between May to September, left upon being informed of the failure. Staff (including the director) applied to the Labour Tribunal claiming outstanding wages, which were granted in terms in default of the company's appearance. By November 2013, the company went into voluntary liquidation.

The test for disqualification of directors, as stated in CWUMPO, is coined in broad terms: "the Court shall disqualify a person where it is satisfied that (i) he is/has been a director of a company which has become insolvent during/after his directorship, and (ii) his conduct as director of that company makes him "unfit to be concerned in the management of a company". The CWUMPO, however, does not go on to define unfitness and must be deduced from case law.

The official receiver based its application for disqualification of the director on the failure to ensure due payment of employee wages. It alleged inter alia that the director should have used the HK$5M funds from October 2012 and US$500,000 from the deal to pay wages as a top priority. The official receiver alleged it was no defence that the director was seeking outside investments, and denied the existence and validity of the deferral agreement. Employees' wages are preferential debts enjoying priority in distribution in liquidation, and non-payment of wages without reasonable excuse is a criminal offence under the Employment Ordinance (Cap. 57), therefore, the official receiver claimed, a breach of such duty itself satisfies "unfitness" and the deferral agreement and deal provide no defence.

After the trial, the court was in favour of the director and found that there was no unfitness. Failure to pay wages by a company does not justify or mandate granting a disqualification against a company director and is only a relevant conduction for consideration. Ordinary commercial misjudgment is not enough. In situations where the director in question had to decide whether to continue operating the company's business at a loss (or with wages unpaid), the test for unfitness is "whether the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation".

The court must consider all circumstances of the case to decide whether such failure to pay was caused by the director's lack of commercial probity, gross negligence or total incompetence in managing the affairs of the company. The basis and reasonableness for believing in the prospect of paying debts concerned in the

future, including the likelihood of finding "white knight" investments and the efforts made by the relevant director, is important. Equally, the nature of the business and the circumstances leading to its demise, and whether relevant creditors (in this case, the employees) were voluntary creditors (i.e. they made an informed decision to agree to deferral of payment) are key considerations. Relevant also is whether the decision to continue operating would have benefited the director to the detriment of general creditors, putting personal interest first.

The court's nuanced approach to the decision makes one thing very clear: directors of businesses facing financial difficulties must not assume that they can wind up their business with impunity. Instead, they would be well-advised to seek legal advice on the steps ahead, gathering evidence on the circumstances leading to insolvency along the way.