

Hong Kong court orders disqualification and repayment as SFC targeting of directors intensifies

In a newly published judgment, the Hong Kong Court of First Instance has ordered that three former directors of First Natural Foods Holdings Limited (the Company) be disqualified from acting as directors for up to twelve years and that the former chairman repay more than HK\$84 million allegedly embezzled from the Company. The judgment comes as the Securities and Futures Commission (SFC) intensifies the targeting of corporate entities and directors it suspects of misfeasance.

Overview

In *Securities and Futures Commission v Yeung Chung Lung*, [2017] HKEC 313, the SFC sought orders disqualifying Yeung and two other former executive directors, Yang Le and Ni Chao Peng, from being directors as well as an additional order that Yeung repay HK\$84,880,000 allegedly embezzled from the Company.

The SFC made the application under section 214 Securities and Futures Ordinance (Cap 571) (the SFO).

Background

The Company was listed on the Main Board of the Hong Kong Stock Exchange in February 2002. Its profit was mainly driven by three operating subsidiaries in Mainland China.

In December 2008, Yeung instructed solicitors to submit to the Stock Exchange an announcement saying

that the Company had dismissed all its employees and was unable to operate (which was false). A few days later, trading in the Company's shares was suspended and new directors appointed. On 6 January 2009, the Company petitioned for its own winding-up on the grounds of insolvency. Provisional liquidators were appointed shortly thereafter. Meanwhile, Yeung, Yang and Ni had disappeared.

Investigation

The provisional liquidators – together with investors from the SFC - began an investigation into the Company's affairs, discovering an apparent trail of false accounting and embezzlement. While the Company had published audited consolidated results apparently showing that the Group was financially strong, subsequent investigations revealed a very different picture.

With the aid of the China Securities Regulatory Commission (CSRC), the SFC obtained copies of bank

Key issues

- The Court ordered disqualification of the former listed company chairman and repayment of HK\$84 million he had apparently embezzled.
- The case highlights the developing close cooperation between Hong Kong and Mainland China regulators.
- The SFC has vowed to make corporate and director misfeasance a top priority in its enforcement efforts.

statements of the Mainland subsidiaries which showed much lower bank balances than those published in the consolidated results. It appeared that the auditors had been shown false bank statements and that the books and records of the main subsidiary had been "*falsely written up so as to pretend [it] had*

substantial cash reserves which were not in fact there."

The bank statements also showed that HK\$84,880,000 of a subsidiary of the Company in Mainland China had been transferred to the accounts of three separate Hong Kong companies, apparently on Yeung's instructions. The SFC said the overwhelming inference must be that Yeung embezzled this sum for his own personal profit.

Section 214 unpicked

The Court spent some time unpicking the various elements to section 214 SFO under which the SFC had brought the application.

The Court did not agree with the SFC that there had been "*oppressive*" conduct under section 214(1)(a). The judge held that in deciding whether a company's affairs have been conducted in a manner oppressive to members under section 214(1)(a), regard should be had to whether a person has acted oppressively *qua* shareholder rather than *qua* director. "*Oppression*" occurs "*when shareholders with a dominant power in the company exercise that dominance as shareholders rather than as directors*".

As the misconduct complained of by the SFC in this case (false announcement, embezzlement, false accounting, obstruction of the provisional liquidators, dispossession of the Mainland subsidiaries) was all committed by those involved *qua* director (and not shareholder), the Court held that the SFC could not make its case under section 214(1)(a).

Applying section 214(1)(b) - that the acts had involved "*defalcation, fraud, misfeasance or other misconduct*" – the Court noted that the limb of "*other misconduct*" had presumably been

added to cover the widest range of possible misconduct. This could include, for example, the failure of a director to exercise the requisite degree of skill and care in the management of a company as may reasonably be expected of a person of his knowledge and experience.

The Court noted where a director had embezzled the company's assets, the director's actions may result in the Company's members "*not having been given all the information with respect to its business or affairs that they might reasonably expect*" (section 214(1)(c)); and that as a result there had been "*unfairly prejudicial conduct*" towards members of the Company (section 214(1)(d)).

Listing Rules

Interestingly, the Court did not agree with the SFC regarding the implications of compliance with the Listing Rules in the context of section 214 of the SFO. As Listing Rules "*are a contract between a company and the Stock Exchange*", the judge was not persuaded a breach of the Listing Rules "*necessarily means the affairs of a company come within the purview of section 214(1) of the Ordinance*." The Court therefore did not consider whether the Listing Rules were breached when determining whether a disqualification order should be made under section 214 in this case.

Disqualification and compensation

On the facts, the Court concluded that Yeung had embezzled the money for his own personal benefit and that his misconduct could be described as unfairly prejudicial towards the Company's shareholders. The Court went on to find that Yeung, Yang and Ni knew about the misstated cash balances and acted fraudulently in

covering up the true state of the Company's financial affairs. There was nothing to refute the SFC's allegation that the Mainland subsidiaries had been put beyond the Company's control by the acts of the three former directors, which again constituted a *prima facie* case of misfeasance or misconduct.

The Court found that Yeung's actions put him into the highest bracket for disqualification and ordered him to be disqualified for 12 years. The Court ordered Yang and Ni to be disqualified for eight years each.

The Court further agreed with the SFC's request that it should use its broad discretion under section 214(2)(e) of the Ordinance to require Yeung to repay the money he had apparently embezzled (together with compound interest) to the legitimate assignee of the Company's claim, a special purpose vehicle set up by the liquidators, notwithstanding that any fresh action by the vehicle would now be time-barred.

Analysis

In his speech last November at the 7th Pan-Asian Regulatory Summit, the relatively new Executive Director of Enforcement at the SFC, Thomas Atkinson, promised a crackdown on corporates and directors who engage in misfeasance. Corporate fraud and misfeasance cases, he said, "*not only caused immense losses to investors, they also severely damaged the integrity and reputation of the Hong Kong markets*".

The SFC appears to be making good on this pledge, with a noticeable uptick recently in investigations into corporate disclosure and governance issues and in court actions against directors of listed companies for alleged breaches of directors' duties,

many of them involving failure to disclose relevant material information to shareholders or personal interests in a transaction. Their success in *Yeung Chung Ling* will no doubt bolster their confidence in their efforts in this regard.

The judgment in *Yeung Chung Ling* highlights another core theme of the SFC's new enforcement approach – increased collaboration between Hong Kong and overseas regulators particularly in relation to PRC-based companies. The bank statements needed to make the SFC's case were only produced through collaboration with the CSRC.

With section 214 now firmly established as a weapon of choice in the SFC's armoury, we can expect further moves aimed at protecting the integrity of the markets and sustaining investor confidence. Such victories are important, as even in cases such as this where the individuals in question have disappeared, they have a deterrent effect. The importance attributed by the SFC to disqualification orders in protecting the integrity of the Hong Kong market, should not be underestimated.

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