

A RECENT HONG KONG COURT REMINDER TO NON-EXECUTIVE DIRECTORS REGARDING THEIR DUTY TO ENQUIRE AND INVESTIGATE IN THE FACE OF RED FLAGS

The recent Hong Kong judgment of *Moulin Global Eyecare Holdings Limited (in liquidation) v Olivia Lee Sin Mei* [2019] HKCFI 1715 reminds non-executive directors (NEDs), in particular those with a professional background, of their duty to exercise care and skill in performing their roles, and the potential consequences they may face if they fail to do so. This is in line with existing English and Australian case law on duties of NEDs.

BACKGROUND

The collapse and insolvency of Moulin Global Eyecare Holdings Limited (Moulin) and its group companies (the Group) due to fraud perpetrated by its senior management is well known. Olivia Lee Sin Mei (Lee) was a non-executive director and member of the audit committee of Moulin. She was an experienced commercial solicitor by profession. Eleven years after commencing litigation against her, the liquidators of Moulin have finally secured a judgment of over HK\$450 million including recovery of cash paid out in cash dividends and via share repurchases by Moulin when insolvent and during Lee's tenure. The Court of First Instance found that Lee had breached her duty of care and skill and failed to investigate multiple red flags.

It is common for professionals to be NEDs of listed companies. It is also not uncommon for senior members of banks, law firms and other professional firms to accept appointment as NEDs of client listed companies. In doing so, they lend their names and the status and prestige associated with such professional firms to the listed companies. Parties dealing with such listed companies may, to a certain extent, place their reliance and trust in such NEDs, particularly given their background and expertise. It is in this context that the victory of the liquidators is particularly significant.

RED FLAGS WHICH LEE FAILED TO INVESTIGATE

By way of background, since at least 1996 and throughout her time as Moulin's NED (between 8 December 2000 and 1 November 2004), Lee was the principal legal adviser to the Group. Lee was also a member of Moulin's audit committee upon its formation in 2000. The court found that Lee's

Key issues

- NEDs, in particular those with a professional background, may face serious consequences for not taking action if they become aware of suspicious circumstances that warrant further investigation.
- NEDs are equal board members, and are expected to contribute to the board or committees based on their expertise and knowledge.
- NEDs should ensure that they have sufficient time to commit for their monitoring role before accepting appointment.
- Those without professional expertise should still be ready to inform appropriate persons and seek advice where required.
- The court will consider causation and whether but for the NED's failure, the wrongful behaviour would have continued.

knowledge of Moulin's internal operations and business transactions far exceeded what the title of NED would normally suggest.

The court found that Lee had acquired knowledge of matters which ought to have caused her serious concern and prompted further inquiry. If properly investigated, the fraud of the senior management would have been revealed and the Group's insolvency could have been uncovered, and no dividends would have been paid and no share repurchases would have been made.

The court identified 5 matters (as discussed below) on which Lee failed to take further action, and accordingly held that she was in breach of her duty of care and skill.

- Lee failed to investigate a complaint by a customer in 2000 involving manipulation of accounts between the customer and the Group. In particular, the customer identified an audit confirmation which showed activity in the amount of US\$1.3 million with an entity which was already dissolved. Lee was retained to advise on the matter. The court considered that had Lee taken steps to investigate the matter, the fraud of the Group's senior management would have been exposed.
- The court considered that the Group's failure to settle the legal fees of Lee's law firm for around 7 months, in circumstances where the consolidated financial statements of the Group covering part of the relevant period recorded a profit of HK\$172 million, should have prompted Lee to question the Group's solvency. The financial statements had been presented to Lee at a board meeting at the relevant time. However, Lee made no further inquiry.
- As at 31 March 2001, the Group had granted cash advances of around HK\$233 million to third parties, representing 17.43% of the Group's net assets, on an unsecured basis. The significance of this is highlighted by the fact that Moulin was a manufacturer and distributor of eyewear, not a money lender. The Group's money lending activities were recorded in the minutes of an audit committee meeting held in December 2001, which Lee attended. The court found that Lee had failed to duly perform her duties in the following circumstances: (a) the Group had no money lender's licence at the relevant time; (b) the Group, as of 31 March 2002, increased its interest-bearing bank borrowing by HK\$420 million (if it had idle cash to support its money lending side business, it would not have had to increase its borrowings), and (c) Lee knew that one of the purported borrowers was not an independent third party, but a member of senior management of the Group.
- KPMG resigned as an auditor in April 2002. The court considered that, as an experienced commercial solicitor, Lee should have realised the seriousness of the resignation of an auditor of a listed company. Lee had just accepted the CEO's explanation for the change, which was KPMG's proposed "unreasonable high fee". In fact, KPMG raised to the CEO a number of serious concerns as to the veracity of the Group's accounts, noting that urgent attention of the management was required. Ernst & Young (EY) was thereafter appointed.
- Lee failed to make enquiries and require investigation notwithstanding EY repeatedly expressing serious concerns at audit committee meetings attended by Lee and in writing to Moulin's board, and threatening to qualify the accounts. At an audit committee meeting on 29 April 2004, Lee was informed of serious issues in respect of the Group's accounts

concerning the veracity of (a) the Group's purported North American customers and purported payments from them; (b) amounts purportedly owed by Mr. Ma, a Chinese subcontractor, which had been assigned to independent third parties to conceal his connection, and (c) the third party advances. However, notwithstanding her accumulated knowledge of the Group's irregularities, at two further board meetings, the Board approved Moulin's financial statements / interim reports and the declaration of dividends.

In respect of the unlawful payment of dividends, the defence of acting honestly and reasonably was available to Lee under section 358 of the old Companies Ordinance (Cap. 32) and section 281 of the Bermuda Companies Act. However, since Lee did not attend the trial, it was found to be purely academic to consider such defence.

As regards the unlawful repurchases of shares, the court considered that, even if a fault element was required (there was a lack of considered argument as to whether it was required), it was still satisfied that Lee was in breach of her duty of care and skill.

GUIDANCE FROM EXISTING ENGLISH AND AUSTRALIAN CASE LAW

Existing English and Australian case law also suggests that NEDs are expected to contribute based on any relevant expertise and must make enquiries and seek advice if red flags are raised and cannot hide behind the fact that they do not have an active role in management. Such failure can lead to serious consequences.

England

In England, executive and non-executive directors alike are under a duty to exercise reasonable care, skill and diligence in their roles. The standard expected of a director with particular knowledge, skills or experience (such as a qualified solicitor or accountant) will be greater where they are responsible for matters that fall within such expertise (for example, reviewing and approving the company's accounts, where the director in question is a qualified accountant).

The principle that NEDs who turn a blind eye to signs of potential misfeasance will be liable for breach of their duties to the company has long been a feature of English company law. For example, in *Dorchester Finance Co v Stebbing* [1977] 7 WLUK 144, the court found that two NEDs (who were also qualified accountants) could not escape liability for allowing the company to make illegal and irrecoverable loans by arguing that they had taken very little or no interest in the affairs of the company, and as such were not aware of this wrongdoing. In so finding, Foster J added: "*for a chartered accountant and an experienced accountant to put forward the proposition that a non-executive director has no duties to perform I find quite alarming...the duties of a director whether executive or not are the same*".

The leading modern authority is *Lexi Holdings (in admin) v Luqman* [2009] EWCA Civ 117, which confirms that NEDs cannot rely on their inactive participation in the company to avoid liability; in this case, the company suffered losses due to fraud perpetrated by the managing director. The Court of Appeal ruled that had the two NEDs performed their duties by making enquiries which would have revealed the fictitious accounts, and had they

informed the other directors and the lending banks of the managing director's criminal record, as well as sought advice, the subsequent borrowing and misappropriation by the managing director would not have happened. This ruling is interesting, made in the context that the court at first instance had found no breach of duty. The reasoning of the court at first instance was that the two NEDs were sisters of the managing director, who was "a persuasive, sophisticated, charming and highly intelligent liar" such that even if they had taken a more active role, they would have been "fobbed off ". The NEDs were ultimately held liable for the whole of the amounts misappropriated by the managing director (each NED liable for around £40 million). This case has been cited with approval in numerous recent decisions including *Raithatha v Baig* [2017] EWHC 2059.

Australia

In Australia, regardless of qualification, all directors are subject to an objective standard of care and skill in relation to the financial affairs of their companies. In *Australian Securities and Investments Commission (ASIC) v Rich* [2009] NSWSC 1229, the court confirmed that the statutory duty imposed on every director (including NEDs) requires each to become familiar with the fundamentals of the businesses of the company, to keep informed about and monitor the company's activities and affairs, and to have a reasonably informed opinion of the company's financial status and capacity.

Similarly in *Australian Securities and Investments Commission v Healey* [2011] FCA 717, it was held that all directors have a responsibility to understand the contents of the financial statements which they adopt. The directors (including six NEDs) were found to have contravened their statutory duty of care and diligence by approving financial statements which misclassified current liabilities as non-current. NEDs cannot substitute reliance on others "for their own attention and examination of an important matter that falls specifically within the Board's responsibilities". As confirmed in *United Petroleum Australia Pty Ltd v Herbert Smith Freehills* [2018] VSC 347, "directors must understand and focus upon the content of financial statements, and if necessary, make further inquiries if matters revealed in these financial statements call for such inquiries".

CONCLUSION

Whilst NEDs are not involved in the day-to-day management of a company, they are expected to carry out their functions which include monitoring and scrutinising the company's performance and reporting. NEDs, as equal board members, are expected to give the board, and any committees on which they serve, the benefit of their skills, expertise, background and qualifications through regular attendance and active participation.

The Moulin case serves to reinforce the fact that the roles of NEDs are not risk-free and may be much more onerous than one would have thought. This is particularly the case given the advanced technology nowadays, which may facilitate fraud and make discovery of the same more difficult. The Moulin case further reminds NEDs of their duty of care and skill, in particular, where they are professionals and/or have gained in-depth knowledge of the company's operations. If they become aware of irregularities of the company, they should make necessary enquiries or instigate investigations, instead of leaving the matter aside or purely accepting the senior management's explanation.

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