



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Guidance note on directors' duties in the context of valuations in corporate transactions

15 May 2017

Introduction

1. The SFC is concerned that, in some transactions, listed companies either do not obtain a valuation when circumstances suggest it would be appropriate or they rely on a valuation to justify a transaction when reliance on the valuation is imprudent. Some of the resulting transactions may cause loss to listed companies and their shareholders by buying something at an overvalue or selling it at an undervalue. The purpose of this Guidance Note is to remind listed company directors of their responsibilities and set out the SFC's expectations of the conduct of directors when considering or approving a corporate transaction that involves the valuation of an asset or a target company.
2. This would apply in the context of acquisitions but all of the principles have equal application to disposals. All references in this Guidance Note to acquisitions should be read as including reference to disposals with any necessary consequential changes.
3. This Guidance Note applies to all directors of a listed issuer of the Main Board or GEM of The Stock Exchange of Hong Kong Limited. The Guidance Note is based on the obligations that the law imposes on directors generally. It is not intended to be an exhaustive or definitive exposition of the applicable legal requirements. It does not replace the relevant law, rules, regulations, codes and guidelines on directors' duties or diminish their requirements. In particular, the conduct of directors of a listed issuer is also governed by the Listing Rules and the Corporate Governance Code.

Background

4. Under section 214 of the Securities and Futures Ordinance (Cap. 571) (SFO), the SFC is able to bring proceedings in the High Court to seek redress for misconduct or other wrongdoing towards a listed corporation or its members by any person responsible for the conduct of the business or affairs of the listed corporation.
5. The SFC may bring proceedings if the business or affairs of a listed corporation have been conducted in a manner:
 - (a) resulting in members or any part of its members not having been given all the information with respect to its business or affairs as they might reasonably expect;
 - (b) involving defalcation (i.e. misapplication including misappropriation of any property), fraud, misfeasance (i.e. doing a lawful act in a wrongful manner) or other misconduct towards it or its members or any part of its members; or
 - (c) that is oppressive or unfairly prejudicial to its members or any part of its members.

Conduct may consist of a single act or a series of acts or any failure to act.

6. The SFC has taken action and obtained court orders under section 214 for breaches of duty by current or former directors of listed corporations that have resulted in loss to the

listed corporation or its subsidiaries. A breach of directors' duties alone is sufficient to constitute "misfeasance" or "other misconduct" and will form the basis of an action under section 214. The director concerned need not have benefited personally from the wrongful conduct. The Court may make a number of orders under section 214, including:

- (a) an order that, for a period of up to 15 years, a person who was wholly or partly responsible for the business or affairs of the corporation having been conducted in the wrongful manner be, among other things, disqualified from being a director, and shall not directly or indirectly be concerned or take part in the management of any corporation (section 214(2)(d));
 - (b) any order the Court considers appropriate, including an order that the person pays compensation (section 214(2)(e)); and
 - (c) an order that the listed corporation brings proceedings in its own name against any person responsible for conducting the business or affairs in the manner complained of (section 214(2)(b)).
7. Under section 214(2)(e), the Court has granted orders requiring directors who have breached their duties and so caused a listed company or its subsidiaries loss to compensate the company for that loss¹. Further, under section 214(2)(b), the Court has also ordered that a listed company bring proceedings against certain of its former directors for compensation for losses suffered as a result of the directors' breaches of duty in respect of a number of the company's investments².
8. The SFC will take into account whether the directors have adhered to this Guidance Note in assessing a breach of directors' duties. The SFC is more likely to investigate and seek orders under section 214 against listed company directors who do not act in accordance with its guidance. The SFC may seek disqualification, compensation and other orders as a result.

General

9. When considering a proposed transaction, directors are under duties:
- (a) to act in good faith in the interests of the company;
 - (b) to exercise due and reasonable care, skill and diligence in the discharge of their duties;
 - (c) to exercise independent judgment;
 - (d) to exercise their powers for proper purposes;

¹ For example, Re First China Financial Network Holdings Limited; Re Styland Holdings Limited; SFC v Li Wo Hing & Others (Re Medical China Limited).

² SFC v Cheung Keng Ching & Others (Re Rontex International Holdings Limited).

(e) to avoid actual or potential conflicts of duty and interest; and

(f) not to make secret profits.

10. In the context of proposed acquisitions of assets/target companies, directors are responsible for determining whether the terms of the transaction including the consideration to be paid are fair and reasonable. As part of this process, it is critical that directors ensure that proper investigation and due diligence on, and appraisal of the worth of, the asset/target company is conducted. These responsibilities are part of the duty imposed on directors of listed issuers by law and the Listing Rules to exercise due care, skill and diligence³. However, assessment of the appropriate consideration to be paid is one aspect of the duties of directors – they must also consider whether the proposed transaction or arrangement is in the interests of the company and its shareholders as a whole and, compared to other investment options, should be proceeded with.
11. Directors may, subject to the company's articles of association/by-laws, delegate particular functions to others below them in the management chain and trust the delegate's competence and integrity to a reasonable extent. But, directors cannot leave their duties to be performed by others and are under a duty to supervise the functions they delegate. Delegation does not absolve a director's responsibility or liability. The same applies if directors engage professional valuers or other advisers to assist in a transaction: directors are nevertheless required to exercise independent judgment and bring their mind to bear on the issues having regard to the advice and opinions of professionals and other experts. A director's unquestioning reliance on valuation reports in circumstances where there is no exercise of independent judgment and it is unreasonable to do so will likely be a breach of the duty of care, skill and diligence owed to the company. Particular aspects of these duties are further highlighted below.

Proper investigation and due diligence

12. In making a decision to invest, directors should carry out independent and sufficient investigation and due diligence, which includes:
- (a) understanding the nature of the asset or the business of the target company to make informed deliberations about the proposed investment;
 - (b) carefully considering all information that is relevant to assessing the merits of the proposed investment;
 - (c) taking all reasonable steps to verify the accuracy and reasonableness of material information that is likely to affect the valuation of the asset/target company, in particular:

³ Section 465 of the Companies Ordinance (Cap. 622) and Listing Rules (Main Board R3.08 and GEM R5.01). The minimum objective standard that all directors must comply with is the standard exercised by a reasonably diligent person with the knowledge, skill and experience that may be reasonably expected of a director carrying out the functions of the director in relation to the company, and so this takes into account the position held by the director and the responsibilities of the director, as well as the nature and type of the particular company concerned. The minimum objective standard may be raised (but not lowered), with reference to the particular knowledge, skills and experience that the director concerned has.

- (i) being satisfied that financial forecasts and assumptions provided in relation to the asset/target company are reasonably justified, with regard to the relevant factors, including its financial status, historical performance, prospects, peer companies operating in the same sector/industry, economic, political and industry conditions and any market for the asset/ target company; and
 - (ii) directors should not accept blindly and unquestioningly any financial forecasts, assumptions or business plans provided; instead directors are under a duty to understand and if necessary verify these as far as reasonably possible;
- (d) seeking assistance of professional valuers or other advisors if appropriate; and
 - (e) seeking further information from the vendor and any other persons if appropriate.
13. When considering the risks posed by a transaction and verifying information provided about the asset/target company, the presence of any of the following non-exhaustive factors are likely to merit closer attention:

Limited track record of acquisition target

- (a) The target is newly set up or the target is a new business or recently started operating a new business line
- (b) The target is loss-making or generating very little profit
- (c) The net assets of the target are minimal or negative

Aggressive assumptions used in forecasts

- (d) Valuations of the asset/target company are based on forecasts with no historical basis
- (e) Forecasts assume aggressive growth

Questionable sales

- (f) The target has entered into non-binding contracts or recently signed new contracts which are then used as a basis for sales projections

Recent share transfers

- (g) There have been recent transfers of shares of the target company at lower valuations than that at which the listed company is being asked to pay

14. If the company announces that the value of the acquired asset or target company has substantially declined within a short period of time after the transaction, this may be an indication that the directors were excessively optimistic or had not performed sufficient due diligence prior to entering into the transaction.

Engaging a valuer

Independent valuation

15. Directors should consider the need for a valuation of the proposed investment by a professional valuer, particularly:
- (a) if the directors do not themselves possess sufficient experience or expertise in either the field of business to which the asset or target company belongs or in valuation;
 - (b) if the target business is new or still in its infancy or the information provided in respect of the business requires professional advice or professional scrutiny in order to properly assess the merits of the investment;
 - (c) given the investment's size relative to that of, or its significance to, the listed issuer;
 - (d) given the risks involved in the transaction or the complexity or nature of the transaction; or
 - (e) if any director of the acquiring company has an actual or potential conflict of interest in the proposed transaction.

Qualification of valuers

16. Directors should ensure that the professional valuer engaged:
- (a) is independent of and has no conflict of interest as regards the listed company/acquiring company, the vendor and the target business and their respective connected persons, and has no personal interest in the success of the proposed transaction;
 - (b) is suitably qualified and of sufficient reputation for the particular assignment such that its opinion will withstand challenge; and
 - (c) has the relevant expertise and adequate resources to perform its role properly.

Provision of all relevant information to valuers

17. Directors must provide all material information likely to affect the valuation as part of the instructions to the valuer so that the valuation can take into account all relevant matters. This is a factor relevant to demonstrating that the directors' reliance on the valuation report produced is reasonable and justified.

Scope of mandate

18. Directors should consider the appropriate scope of the valuer's mandate, which should ensure that the valuation report will be relevant and useful in aiding the directors to determine the fair and reasonable price for the asset/target company and they can reasonably rely on the valuation in their decision making. It will not normally be sufficient for the directors to simply provide the vendor's projections, forecasts or profit guarantees to the valuer and request a valuation of the target company on the assumption that those projections, forecasts or profit guarantees will be met.

Engaging other advisers

19. The same principles apply (with such modifications as are necessary in the circumstances) to other advisers or experts the directors engage to assist with a transaction. In the situation where a listed company appoints a financial adviser to assist in a transaction⁴, the directors should draft the scope of review and mandate of the financial adviser (in consultation with the financial adviser) appropriately for the matter at hand, including reviewing the reasonableness of any relevant assumptions to be made in the valuation. In cases where the corporate transaction involves valuation by a valuer, directors should draft the terms of the mandate of financial advisers so as to ensure that the financial advisers will carry out the requirements set out in the SFC's Corporate Finance Adviser Code of Conduct, especially, paragraph 5.3(a) and where applicable, paragraph 5.3(b)⁵.

Reliance must be reasonable

20. Whilst directors should engage the services of a professional valuer if it is appropriate to do so, conversely, placing excessive or unquestioning reliance on a valuation report or the advice of any other adviser, may amount to a breach of duty. Directors' reliance on a valuation report must be reasonable in all the circumstances. Directors have a positive duty to devote the necessary time and attention to bring their own judgment to bear on the matter and make an informed decision with regard to a proposed investment, which includes:
 - (a) maintaining an engaged and critical attitude towards the basis of computation, scope of review, assumptions, limitations and qualifications and valuation methodologies on which a valuation is based;
 - (b) analysing the valuation report, which includes reading the actual valuation report and not only relying on a summary prepared for or by management;
 - (c) enquiring with the valuer to satisfy themselves about the valuation and its assumptions or methodology etc.; and

⁴ The appointment of a financial adviser is not mandated by the Listing Rules for all transactions. Separately, an independent financial adviser is required to be appointed under the Listing Rules for certain transactions.

⁵ The requirements of paragraph 5.3(b) of the Corporate Finance Adviser's Code of Conduct do not apply to work performed by: (i) a property valuer in respect of a valuation of real property if it is a member of a relevant regulatory or professional body; (ii) legal advisers in respect of their legal advice; and (iii) accountants in respect of the audit of results and accountants' reports derived from that.

- (d) calibrating the degree of directors' involvement in the transaction having regard to the reasonably anticipated risks involved, the size or significance of the assets/target company being acquired, nature of the transaction and any other matter calling for critical and detailed attention.