

DIRECTORS BEWARE: WHEN NON-DISCLOSURE OF A CONFLICT OF INTEREST BECOMES FRAUD

Overview

The recent decision of the Court of Final Appeal (CFA) in *HKSAR v Mak Kwong Yiu & Ors* highlights a few key points for all directors, especially those of Hong Kong listed companies:

- directors are under a strict fiduciary duty to disclose fully and honestly any conflict of interest to the board;
- any dishonest concealment of conflicts in breach of fiduciary duties may result in **criminal liability**. This risk is heightened in the context of a connected transaction (CT); and
- the courts take a **substance over form** approach when assessing transactions under the Listing Rules.

Facts of the case

A Hong Kong listed company (Listco) issued a series of bonds and appointed a third party intermediary as placing agent. In parallel, the intermediary entered into back-to-back sub-placement arrangements with a connected person of Listco (Connected Person), to whom the bulk of the commission was passed. In substance, the Connected Person carried out the entirety of the bond placement, while the intermediary performed only a limited administrative and document-holding role. The arrangements resulted in approximately HK\$50 million in commission being paid to the Connected Person.

The placement structure was devised and implemented under the direction of an executive director of the Listco, who, together with two other directors, had indirect interests in the Connected Person. However, the role of the Connected Person, the flow of commissions, and the related conflicts of interest were not disclosed to the board or the Stock Exchange. Charges of conspiracy to defraud were brought against the executive director, two senior officers of the Listco who were involved, and the general manager of the intermediary.

Approach taken by the courts

The District Court convicted the defendants of conspiracy to defraud¹ the Listco, its shareholders, potential investors and the Stock Exchange. The convictions were set aside by the Court of Appeal but restored by the CFA on appeal.

The CFA decision

The CFA held that the defendants:

- (i) dishonestly concealed a conflict of interest from the board, depriving it of the opportunity to address the situation in the interests of the company and exposing the company to the risk of economic loss (**First Charge**); and
- (ii) dishonestly concealed facts from the Stock Exchange to preclude its legitimate inquiry into compliance with the CT rules (**Second Charge**).

The First Charge, which centered on the dishonest concealment of a director's conflict of interest in breach of fiduciary duties owed to the Listco, was sufficient in itself to support a conviction for conspiracy to defraud, even in the absence of a CT.

The Second Charge concerned the impediment of the Stock Exchange's performance of its duties in enforcing the CT rules. While there was no direct contractual relationship between the Listco and the Connected Person, the CFA adopted a substance over form approach and held the arrangements constituted a CT. On the facts, it was clear that the Connected

¹ The elements of conspiracy to defraud (as set out in *Mo Yuk Ping v HKSAR*) are broadly: agreeing with others to use dishonest means to cause economic loss to, or put at risk the economic interests of, another person, or to cause a person to act contrary to his public duty.

Person was the real placing agent. To establish liability, it was not necessary for the defendants to know “for sure” that their scheme was ineffective in avoiding the CT regime. It was sufficient that they used dishonest means to preclude legitimate inquiry into what was at best a doubtful transaction.

Key takeaways for all company directors and officers

- Full and fair disclosure - the case serves as a reminder that directors’ fiduciary duties² include a duty to disclose fully and honestly any conflict of interest to the board. Dishonest concealment may result in not only regulatory and civil consequences, but also potentially criminal liability when it deprives the board of the opportunity to exercise independent judgment and may expose the company to economic loss.
- Serious legal liability resulting from any attempt to avoid scrutiny - non-disclosure of a conflict, even in the absence of a CT, can support a finding of conspiracy to defraud. Where a CT (whether actual or potential) is involved, the risk of criminal liability is heightened, especially where non-disclosure may impede the proper discharge of the regulators’ duties. Listed companies and their directors should therefore be cautious that any transaction structuring which is (or would reasonably be seen as being) intended to avoid regulatory scrutiny can pose some significant risks of legal or even criminal liability. The decision confirms the fact that the non-statutory nature of the Listing Rules does not provide any safe harbour from criminal liability where there has been dishonest concealment.
- Substance over form - a CT does not necessarily require a direct contractual relationship between a listed company and a connected person. The courts will look at the substance of a composite transaction and assess the overall arrangement as a whole, and this approach may generally extend to all transactions governed under the Listing Rules.
- Robust risk management and internal control (RMIC) systems - the Stock Exchange recently issued [Practical Tips to Effective RMIC Systems](#) highlighting the importance for the board, management and audit committee to maintain effective RMIC systems to ensure compliance with the Listing Rules and prevent and detect fraud.

The CFA decision is a timely reminder that a failure to disclose conflicts can carry very serious consequences for directors and officers. In structuring arrangements of a company, directors and officers should always consider its substance and not merely its form and, if there is any doubt as to its legal or regulatory implications, should seek advice at the earliest opportunity.

² Directors of HK-listed companies are required to discharge fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with the standard established by Hong Kong law (Listing Rule 3.08). More broadly, all directors of Hong Kong companies, including those of non-listed companies, are subject to fiduciary duties and duties of skill, care and diligence under common law and the Companies Ordinance.

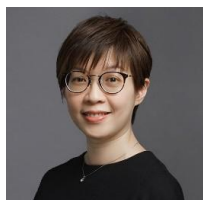
CONTACTS



BENITA YU
SENIOR PARTNER
T: + 852 2901 7207
E: benita.yu@slaughterandmay.com



JASON WEBBER
PARTNER
T: + 852 2901 7212
E: jason.webber@slaughterandmay.com



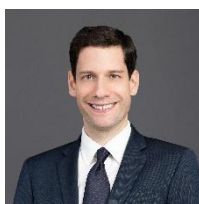
LISA CHUNG
PARTNER
T: + 852 2901 7268
E: lisa.chung@slaughterandmay.com



CLARA CHOI
PARTNER
T: + 852 2901 7217
E: clara.choi@slaughterandmay.com



JING CHEN
PARTNER
T: + 86 105965 0602
E: jing.chen@slaughterandmay.com



RALPH SELLAR
PARTNER
T: + 852 2901 7204
E: ralph.sellar@slaughterandmay.com



JUSTIN CHAN
PARTNER
T: + 852 2901 7208
E: justin.chan@slaughterandmay.com



VINCENT CHAN
PARTNER
T: + 852 2901 7220
E: vincent.chan@slaughterandmay.com



JASON CHENG
COUNSEL
T: + 852 2901 7211
E: jason.cheng@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

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