Introduction

The Australian Government, in its Improving Bankruptcy and Insolvency Laws Proposals Paper issued on 29 April 2016 ("Proposal"), has proposed, inter alia, to introduce a “safe harbour” for directors from personal liability for insolvent trading. This newsletter will give a brief introduction of the safe harbour provision and discuss its applicability in Hong Kong.

Liability for Insolvent Trading

Currently, under section 588G of the Australian Corporations Act 2001, a company director may be liable, if:-

1. he is a director of a company at the time when the company incurs a debt;
2. the company is insolvent at that time, or becomes insolvent by incurring that debt; and
3. at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.

The Proposal identified the threat of personal liability of directors, combined with uncertainty over the precise moment a company becomes insolvent, as a driver behind companies entering into voluntary administration, even in circumstances where the company may be viable in the long run. Due to a fear for liability, directors are disinclined to take reasonable commercial risks to undertake a restructure plan.

Proposed Safe Harbour

In recognition of the rigidness, the Australian Government has formulated two alternative proposals for the introduction of a ‘safe harbour’ either as a defence (Model A) or a carve-out (Model B) to the insolvent trading offence.

Model A

Under Model A, it is proposed that it would be a defence to insolvent trading offence if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by a restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so. The Proposal emphasised that the restructuring adviser must be appropriately experienced, qualified and well informed of the company’s financial position. Also, the restructuring adviser must be provided with appropriate books and records within a
reasonable period of their appointment to enable them to form a view as to the viability of the business. The onus lies with the company directors to ensure that the experience and qualifications of the restructuring adviser were appropriate according to the nature and circumstances of the company.

**Model B**

Model B, on the other hand, contemplates safe harbour as a carve-out, rather than a defence. It provides that the insolvent trading provision does not apply:

1. if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and
2. the person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its directors as a whole; and
3. incurring the debt does not materially increase the risk of serious loss to creditors.

As Model B operates as a carve-out, the burden of proof would lie on the liquidator bringing a claim to show that a director had breached any of the three limbs of the provision. According to the Proposal, the early engagement with shareholder, creditors and appointment of appropriately qualified and experienced restructuring adviser would form part of the “reasonable steps” consideration.

**Lessons for Hong Kong**

Back in mid-1990s, there was discussion in Hong Kong regarding the introduction of an insolvent trading provision, which closely mirrors the wrongful trading provision of the UK Insolvency Act 1986. The purpose of the introduction of the insolvent trading provision is to encourage better corporate governance. It was designed to raise the awareness of company directors of their duty to creditors, rather than just having regard to the interests of themselves or the shareholders.

At the same time, the Report of the Law Reform Commission of Hong Kong on Corporate Rescue and Insolvent Trading (1996) recognized that the insolvent trading provision should not be so harsh as to discourage responsible persons from taking the time to consider, and to seek advice, as to whether a company could be saved or go into liquidation. Nor should the provision make the responsible persons more inclined to push companies into voluntary liquidation or receivership unnecessarily, for fear of being made liable for trading while insolvent. The Report also recognized that responsible persons who paid attention to their business, and who took appropriate action when faced with insolvency, should never face an application in respect of insolvent trading.
Despite great efforts of the Law Reform Commission, the proposal on insolvent trading was eventually abandoned and now almost 20 years later, no such law has been enacted in Hong Kong. However, over the years, the Hong Kong Court has, within the restraint, gradually developed the law relating to insolvent trading. In the case of *Re Ching Hing Construction Co Ltd* [2001] HKEC 1402, the Court held that if the directors of a company continue to trade when the company is making losses and when it should have been apparent that there was no real prospect that the company would return to profitability, the Court may draw the inference that the directors’ decision was improperly influenced by their desire to continue in office and in control of the company and to draw remuneration and other benefits for themselves. Such finding is capable to ground a misfeasance claim against the directors under section 276 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32).

Further, in the matter of *Moulin Global Eyecare Holdings Limited (in liquidation) & Ors v Olivia Lee Sin Mei* [2012] 4 HKLRD 263, (2014) 17 HKCFAR 466, Barma J, remarkably, allowed the liquidator to add a claim based on increase in net deficiency. In essence, the liquidator claimed that at material time, the defendant, acting as a non-executive director of the company, knew or ought to have known, that the company was insolvent and there was no hope to trade out of insolvency. She should have procured the appointment of provisional liquidators, or otherwise blown the whistle. But she did not. Instead, she left the company to trade on and as a result, there was an increased net deficiency of HK$1.23 billion by the time the company was wound up. On appeal, Barma J’s order was set aside, but restored by the Court of Final Appeal. While the final outcome is still pending, the *Moulin* case demonstrates the possibility of a claim based on insolvent trading.

In around 2009, the Financial Services and Treasury Bureau has undertaken a review of the Corporate Rescue Scheme and, among other things, proposed to introduce a new insolvent trading provision. Public consultation was also launched to solicit views on the legislative proposals. But it is now unclear when the relevant proposals would be introduced into the Legislative Council. Nevertheless, it is submitted that the Australian Government’s proposal on “safe harbour” is of good reference value for Hong Kong, as it strikes a better balance between encouraging entrepreneurship and protecting creditors. Also, it is submitted that the Model B, which is similar to the model adopted in the UK Insolvency Act, might work better in the Hong Kong context, as it allows the directors of distressed companies to spare more time on working out a plausible restructure plan, which is in the best interest of the company as a whole.