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柯伍陳律師事務所

# Corporate Insolvency Law and Practice for Officers

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## Outline

1. Procedures of companies winding-up
2. Restructuring and rescue options
3. Impact of winding-up on prior transactions
4. Directors' and employees' personal liabilities in winding-up



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## 1. Procedures of winding-up: the law

- Companies Ordinance (mainly Part V (sections 169 – 296))
- Companies (Winding-up) Rules



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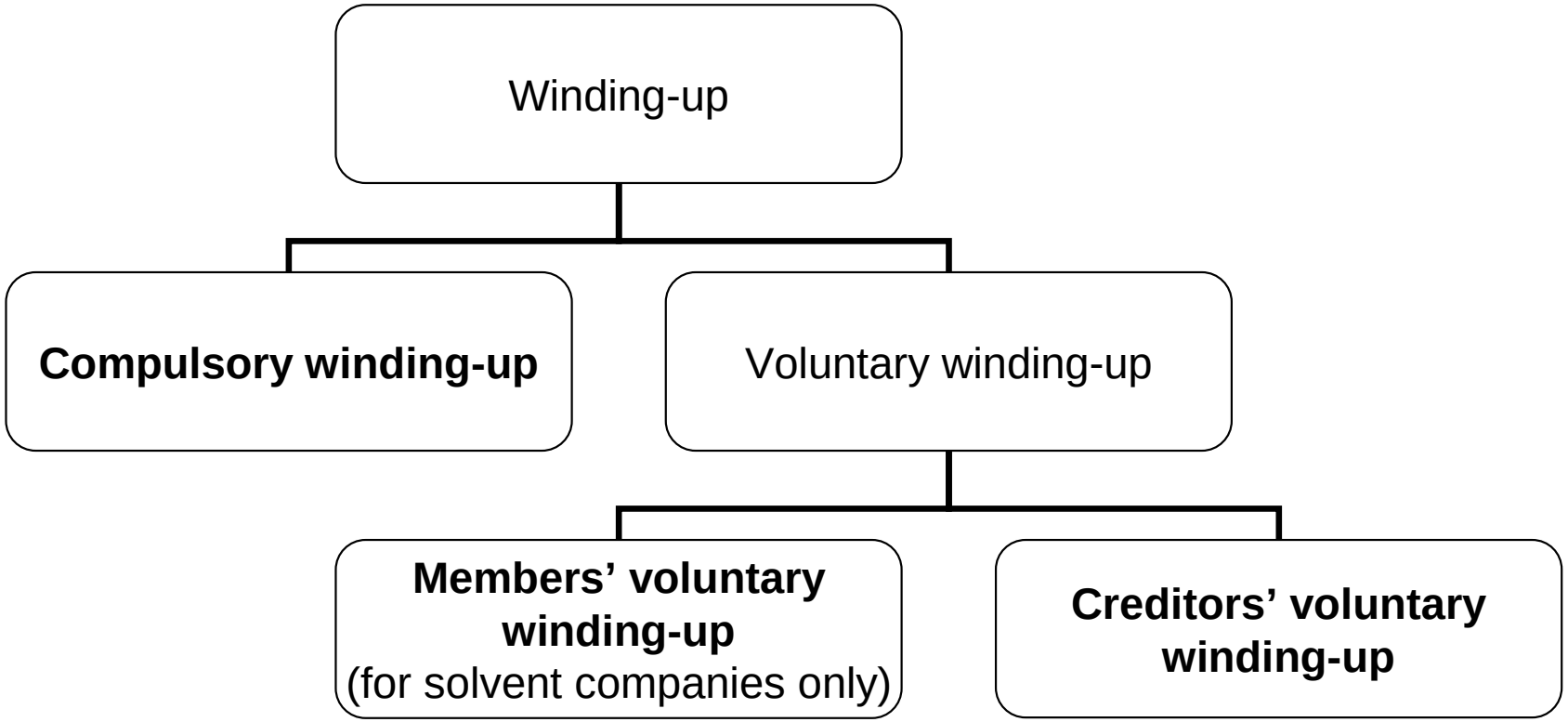
# Procedures of winding-up: types of winding-up



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## Compulsory winding-up

- The court makes an order to wind up a company.
- Common scenarios of compulsory winding-up:
  - Insolvency: for example, when a company is “unable to pay its debts” (s. 177(1)(d) CO).
  - Shareholders dispute in private companies (s. 177(1)(f) CO).
- Compulsory winding-up is commenced by way of a winding-up petition by the company itself, creditor, etc.
  - Date of **presenting the petition** is deemed to be date of commencement of winding-up (s. 184 CO).

## Compulsory winding-up (cont'd)

Pay Official Receiver ("**OR**")'s deposit of $12,150

↓

Pay court fee for filing petition $1,045

↓

**Issue petition** with hearing date endorsed on the sticker (s. 179 CO)

↓

[Appointment of Provisional Liquidators, if necessary (s.193 CO)]

↓

Serve petition on the company, OR and Chief Bailiff within 24 hours of issuance

↓

File verifying affidavit within 4 days of issuance

↓

Advertise petition at least 7 days before hearing

# Compulsory winding-up (cont'd)

↓

Before hearing: (CWUR r. 30, 31)

1. Parties interested in attending hearing prepare notice of intention to appear at hearing and send to petitioner/solicitors
2. Petitioner prepares list of parties attending the hearing

↓

**Hearing**

↓

**Winding-up order** made / Appointment of Liquidators (s.180 & 194 CO)

↓

Winding-up order declined with appropriate costs order / Adjournment /

↓

Petitioner files copy of court's order with CR (s. 185 CO)

↓

Company states its liquidation in every invoice, order for goods, business letters, etc. (s. 280 CO)



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## Compulsory winding-up (cont'd)

↓

Liquidators investigate into the company's affairs (s.221 CO).

↓

Liquidators collect the company's assets.

↓

Accept / adjudicate proof of debt (s.227E CO)

↓

Liquidators distribute the company's assets to creditors

↓

Closing of liquidation

## Petition vs winding-up order

- When a winding-up **petition** is filed, the company is **not** wound up immediately but pending a winding-up order.
  - The director is still subject to his duties owed to the company in operating the business.
- Once a winding-up **order** is made, the commencement of the winding-up will be **deemed** to be the date of the presentation of the petition.
  - Any transaction shall be subject to the **validation order** from the court under s. 182 CO.

## Members' voluntary winding-up

- A **solvent** company passes a **special resolution** for voluntary winding-up.
- Common scenarios of members' voluntary winding-up:
  - Group restructuring.
  - Company ceases to operate.
- Members' voluntary winding-up is commenced by the passing of the company's special resolution for voluntary winding-up.
  - The directors of the company are required to issue a **Certificate of Solvency** to certify that the company will be able to pay its debts in full for a period of up to 12 months from the commencement of the winding-up.
  - Date of **passing of the special resolution** for voluntary winding-up is deemed to be date of commencement of voluntary winding-up (s. 230 CO).

## Members' voluntary winding-up (cont'd)

| | |
|---|---|
| Board meeting forms opinion that company is solvent for a period of at most 12 months after commencement of the proposed winding-up | (s. 233 CO) |
| ↓ | |
| Directors issue a Certificate of Solvency with statement of affairs of the company | (s. 233 CO and Form W1) |
| ↓ | |
| Certificate of Solvency issued within 5 weeks before passing of special resolution for voluntary winding-up and filed with CR not later than the filing of that resolution | (s. 233(2)(a) CO) |
| ↓ | |
| Obtain consent of proposed liquidator to his appointment | |
| ↓ | |



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## Members' voluntary winding-up (cont'd)

| | |
|---|---|
| Convene EGM on 21 days' notice (or shorter if consented) to members | (s. 116 CO) |
| ↓ | |
| Pass special resolution for voluntary winding-up and appointment of liquidator | (s. 228, 235 CO) |
| ↓ | |
| File special resolution with CR within 15 days and advertise notice of special resolution for voluntary winding-up in the Gazette within 14 days, insert copy of resolution to every print of M&A | (s. 117, 229 CO) |
| ↓ | |
| Liquidator publishes notice of his appointment in the Gazette and registers with CR within 21 days of appointment | (s. 253 CO) |

## Creditors' voluntary winding-up

- CVL happens when a company:
  - (1) passes a **special resolution** for voluntary winding-up in the absence of a Certificate of Solvency; or
  - (2) is not solvent in the opinion of
    - the director (straight CVW) or
    - the liquidator (Conversion from members' voluntary winding-up).

  (see s. 228A, 223(4) and 237A CO)

# Creditors' voluntary winding-up (excluding s. 228A proceedings) (cont'd)

Board resolution to convene EGM and creditors' meeting, determine date for EGM and creditors' meeting (appoint director to preside the EGM and creditors' meeting) (s. 241 CO)

↓

Send 21 days' notice (or shorter period as allowed) of EGM to shareholders and notice of creditors' meeting to creditors simultaneously (s. 241 CO)

↓

Advertise notice of creditors' meeting in Gazette, English and Chinese newspaper (s. 241 CO)

↓

EGM held and passed special resolution for voluntary winding-up

↓

Creditors' meeting held on the same day of EGM or day afterwards

↓

Chairman signed minutes of EGM and at least 3 copies of special resolution for voluntary winding-up and appointment of liquidator and notice of confirmation of appointment of liquidator

↓

# Creditors' voluntary winding-up (cont'd)

| | |
|---|---|
| One copy of special resolution to be filed with CR within 15 days, advertised in Gazette within 14 days and inserted into every print of M&A | (s. 117, 229 CO) |
| Director and proposed liquidator attend Creditors' Meeting and answer creditors' questions. Director lays statement of affairs and creditors list in EGM | (s. 241 CO) |
| Creditors have top priority to appoint liquidator. If creditors do not nominate any, the person nominated by company shall become liquidator | (s. 242 CO) |
| Creditors may appoint committee of inspection of not more than 5 persons | (s. 243 CO) |
| Chairman signs minutes of the creditors' meeting and at least 3 copies of Notice of Confirmation of Appointment of Liquidator | |
| Liquidator publish notice of his appointment in Gazette and register with CR within 21 days of his appointment | (s. 253 CO) |

# Voluntary Winding-up by Directors (s.228A)

Directors' meeting called and a majority of them resolve to deliver a winding up statement of the Registrar (s. 228A(1) CO)

↓

Statement to be made by one of the directors recording that (s. 228A(1) & (2) CO)

i) company cannot because of its liabilities continue its business;

ii) The directors consider it necessary that the company be wound up;

iii) It is not reasonably practicable for the winding up to be commenced under another section of the CO

iv) Meetings of the company's shareholders and creditors will be held within 28 days of the filing of the declaration with the Registrar

↓



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# Voluntary Winding-up by Directors (s.228A) (con't)

| | |
|---|---|
| Statement filed with the Registrar within 7 days after it has been made | (s. 228A(3) CO) |
| Provisional Liquidator shall be appointed forthwith after the statement has been filed | (s. 228A(5)(b) CO) |
| Within 14 days of the appointment of the provisional liquidator, a notice of appointment shall be delivered to the Registrar and the notice of the commencement of the winding up and the details of the provisional liquidator be advertised in the Gazette | (s. 228A(9) CO) |
| Send 7 days' notice to creditors and advertise in the Gazette and one Chinese and one English newspaper for the creditors' meeting | (ss. 228A(17) & 241 CO) |
| Creditors' meeting be held within 28 days from the filing of the statement | |



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## 2. Restructuring and rescue options

- Currently, there is no statutory provision for corporate rescue in Hong Kong.
- Nevertheless, corporate rescue may be carried out indirectly through:
  1. Voluntary restructuring;
  2. Formal scheme of arrangement; or
  3. Appointment of provisional liquidator.

## Voluntary restructuring

- **Informal and non-statutory** arrangements between the company, all shareholders, and creditors on a voluntary basis.
- The parties may adopt the Hong Kong Approach to Corporate Difficulties published jointly by the Hong Kong Association of Banks (HKAB) and the Hong Kong Monetary Authority as the guiding principles for the conduct of corporate restructuring.
- Limitation
  - The voluntary nature of this route requires the consent and cooperation of all parties involved.
  - The lack of moratorium and the law about unfair preference make it difficult to accomplish voluntary restructuring.

## Formal scheme of arrangement

- Companies and creditors/members may reach compromise agreements and apply for the **court's sanction** under s. 166 CO.
  - The court may order a meeting of the creditors/members for approving the proposed scheme of arrangement.
  - With approval (by voting) by 75% of the creditors/members (in value) and 50% by head count, the scheme becomes binding on all creditors/members.

## Formal scheme of arrangement (cont'd)

- Limitation:
  - This method requires intensive court involvement and is generally expensive and time-consuming.
  - A pending application for statutory scheme of arrangement under s. 166 CO does not confer a creditor moratorium.
    - Before the proposed scheme is sanctioned by the court, creditors can still commence legal proceedings against the company or seek to wind-up the company.
    - This often hinders the parties from reaching a compromise.

## Appointment of provisional liquidator

- In some situations, a provisional liquidator may be appointed under s. 193 CO for the purpose of corporate restructuring.
  - The liquidators may also apply to the court under s. 166 CO to have a proposed scheme of arrangement approved and implemented.
- Appointment of a provisional liquidator has the effect of a moratorium because of s.186 CO.
- This is often used in conjunction with s.166 CO to achieve corporate restructuring.

## 3. Impact of winding-up on prior transactions

- Transactions after Commencement of Winding Up
  - Section 182, Companies Ordinance
- Unfair preferences
  - Section 50, Bankruptcy Ordinance (extended application to companies by Section 266B, Companies Ordinance)
- Fraudulent conveyance
  - Section 60, Conveyancing and Property Ordinance
- Avoidance of Floating Charge
  - Section 267, Companies Ordinance

## Transactions after Commencement of Winding Up

- S. 182 CO provides:

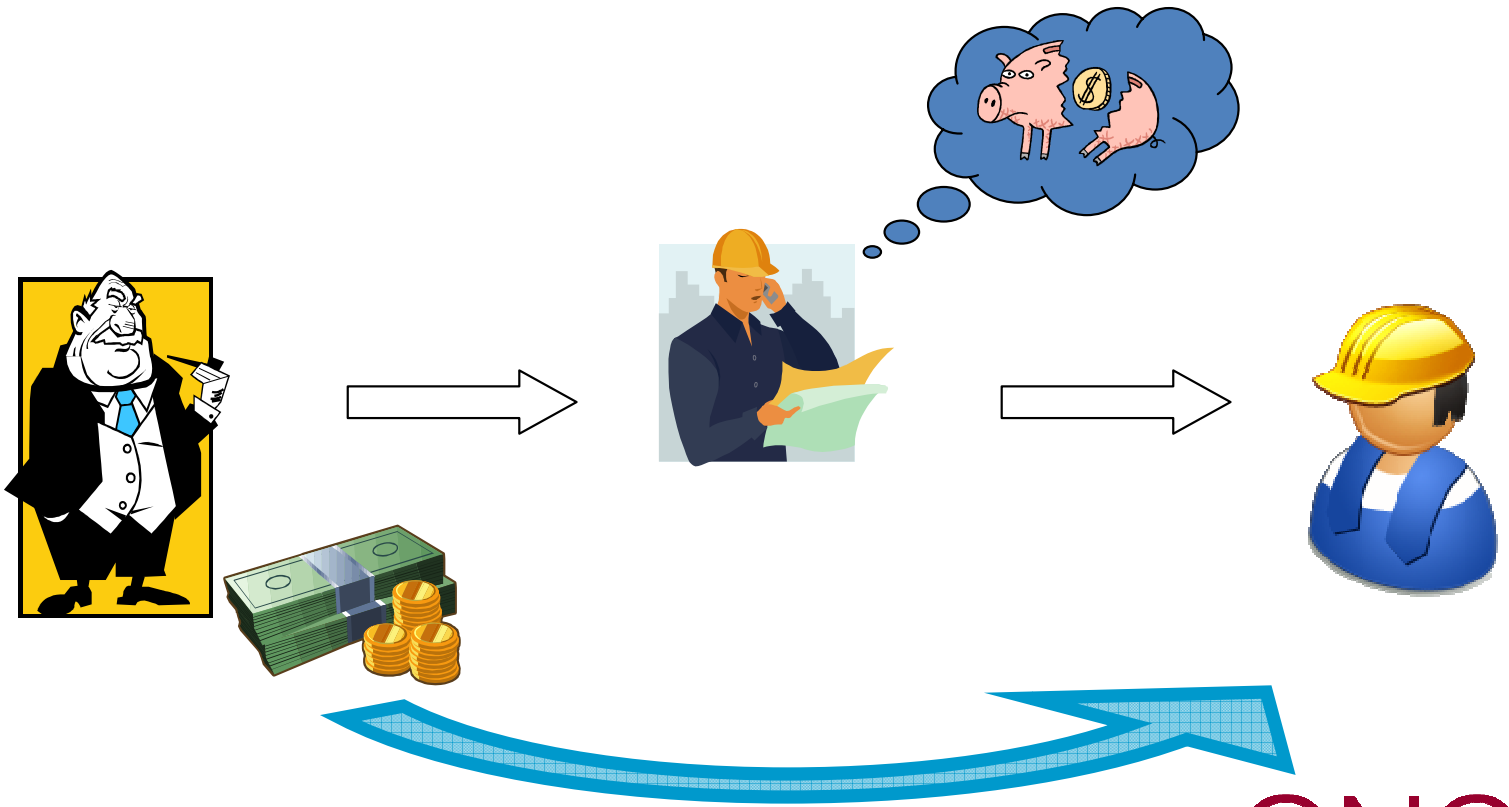
  "In a **winding up by the court**, any **disposition of the property of the company**, including things in action, and any transfer of shares, or alteration in the status of the members of the company, made **after the commencement of the winding up**, shall, unless the court otherwise orders, be **void**."

## Transactions after Commencement of Winding Up

- Only applicable to compulsory winding up.
- Relevant to the period between presentation of petition and appointment of liquidators or provisional liquidators.
- Disposition of property can be direct or indirect: see *Chevalier (HK) Limited v Right Time Construction Company Limited* CACV 120/1989.

## *Chevalier (HK) Limited v Right Time Construction Company Limited*

- Main Contractor made direct payment to sub-sub-contractor after Sub-Contractor commenced winding up.





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## *Chevalier (HK) Limited v Right Time Construction Company Limited* (cont'd)

- Held:
  - S.182 CO infringed.
  - Sub-sub-contractor had to refund to sub-contractor.

## Unfair preference

- Requirement
  - A creditor (or guarantor) was put in a better position (than other creditors) by the transaction (s. 50(3)(a) BO).
  - The transaction was influenced by the debtor's "desire to prefer" the recipient (s. 50(4) BO).
  - The debtor company must be insolvent at the time of the transaction.
  - The transaction must take place within the relevant time.
- Relevant time
  - 6 months for non-associates.
  - 2 years for associates .

## Unfair preference (cont'd)

- Remarks
  - The "desire to prefer" is presumed in the case of "associate".
  - However, the scope of "associate" is limited.
    - Serious gap arises when the concept of "associate" under BO (which applies to personal bankruptcy) is transplanted to s. 266B CO (which applies to corporate debtor under).

## *Hau Po Man Stanley* [2005] 2 HKC 227

- Debtor (a dentist) borrowed $1.5 million from sister.
- Within two years, he repaid the loan and then petitioned for his own bankruptcy.
- Three repayments were made by debtor to sister at different time.
- High Court held no unfair preferences.
- Creditor appealed.
- Court of Appeal held (2:1):
  - No unfair preference for the first two repayments, because:
    - Sister and husband chased hard (sent letters, quarrels, went to his clinics, threatened to cut off relationship) caused considerable pressure on debtor.
    - Hence, the payment was not made with “desire to prefer”. The presumption of preference was rebutted.
    - The third payment, made a few months later, and after another creditor started legal action, was an unfair preference.

## *Re Sweetmart Garment Works Limited (In Liquidation)* HCCW 755/2005 [2008] HKCU 173

- The Company went into compulsory liquidation on a creditor's petition.
- A little over a month prior to the presentation of the petition, the Company granted a mortgage over a yacht in favour of HSG Nordbank AG, a non-associate of the Company.
- The loan was drawn down three days later and used to repay an existing overdraft of the Company with the Bank.
- Following presentation of petition, the Bank exercised its right under the mortgage and took possession of the yacht. The vessel was sold and a sum was realized after the deduction of sale expenses.
- The liquidators sought a declaration that the mortgage constituted an unfair preference in favour of the Bank.

## *Re Sweetmart Garment Works Limited (In Liquidation)* (cont'd)

Held:-

- There was a desire to prefer the Bank.
- There is no need for there to be direct evidence of the requisite desire. Its existence may be inferred from the circumstances of the case.
- The requisite desire must be one of the factors which operated on the minds of those who made the decision. It needed not be the only factors or even the decisive one.

## *Re Sweetmart Garment Works Limited (In Liquidation)* (cont'd)

- Having reviewed the contemporaneous correspondence between the Bank and the Company and the evidence of the steps being taken by other creditors of the Company, the judge found that the steps taken by the Bank were too mild and unspecific, which could not sensibly be regarded as constituting pressure on the Company in any real form.
- In stark contrast, the steps taken by the other creditors were "more concrete, more serious, and instituted much more promptly" than those threatened by the Bank.

## *Re Sweetmart Garment Works Limited (In Liquidation)* (cont'd)

- Also, given it did not appear that there could have been any real prospect of the Company trading through its difficulties, it could not be said that the mortgage was granted to preserve the ongoing commercial relationship with the Bank.
- Furthermore, even though personal bankruptcy proceedings were threatened against the Company's directors by other creditors consequent on the service of statutory demands against them, on the very day the vessel was offered to the Bank as security. The judge took this as strong evidence of a desire to prefer the Bank.

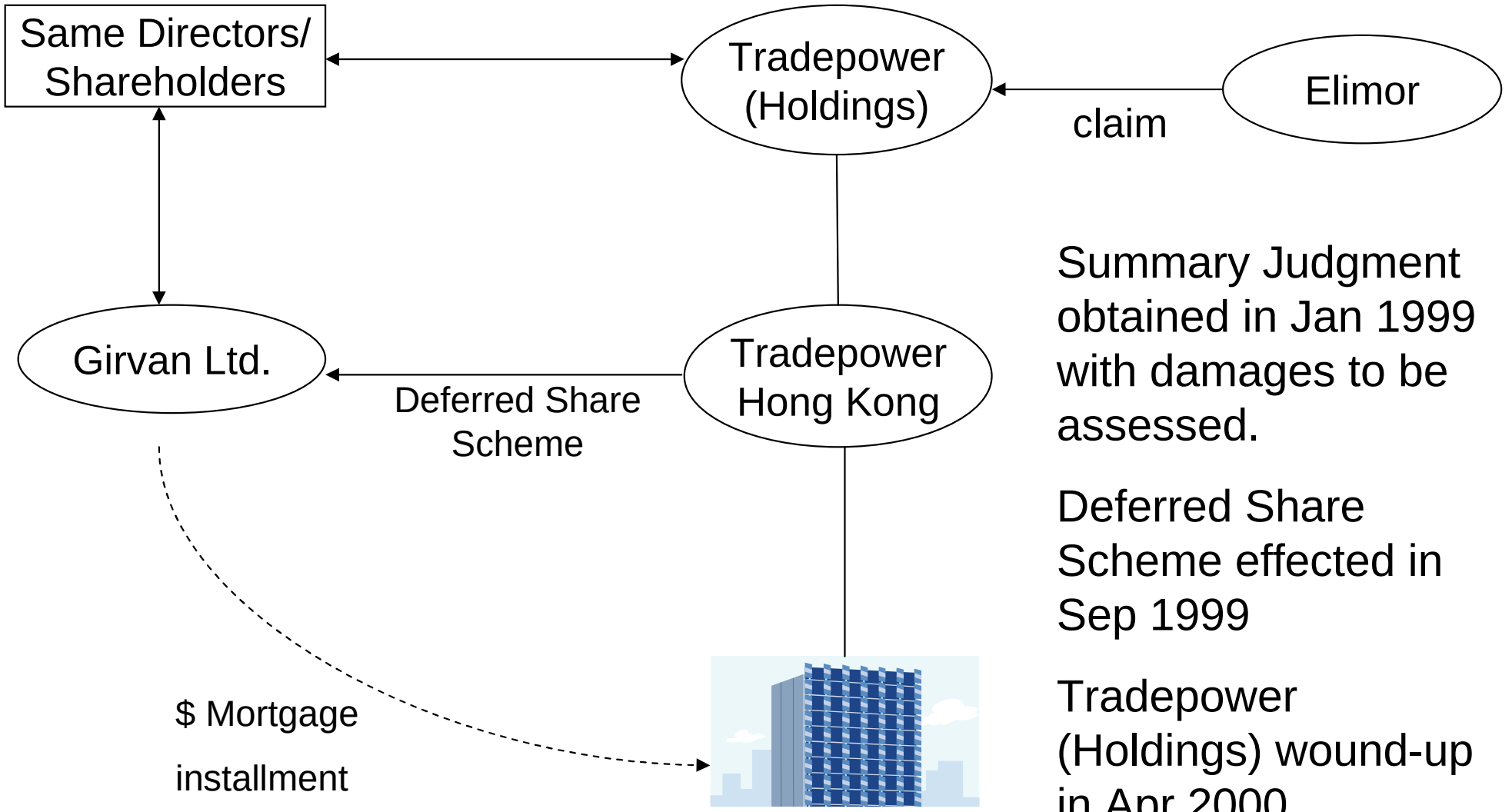
## Fraudulent conveyance

- S.60, Conveyancing and Property Ordinance provides:

"(1)…every disposition of property made…with **intent to defraud creditors**, shall be voidable, at the instance of any person thereby prejudiced."

(3)This section does not extend to any estate or interest in property disposed of for valuable consideration and in good faith or upon good consideration and in good faith to any person not having, at the time of the disposition, notice of the intent to defraud creditors."

## *Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and Others* FACV 5/2009




Summary Judgment obtained in Jan 1999 with damages to be assessed.

Deferred Share Scheme effected in Sep 1999

Tradepower (Holdings) wound-up in Apr 2000



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## *Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and Others* (cont'd)

- The liquidators brought claim against the Girvan and the former directors under s.60 of the Conveyancing and Property Ordinance (Cap.219) and for breach of fiduciary duties.

## *Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and Others* (cont'd)

- The trial judge dismissed the liquidators' action:
    - Following the authority of *Lloyds Bank v Marcan* [1973] 1 WLR 1387 , 'intent to defraud' in s. 60 means actual subjective intent to defraud creditors.
    - It could be negated if the directors were motivated by other legitimate concerns.
    - In this case the directors were primarily motivated by their concerns over Girvan's position, which having financed the mortgage payments, had not obtained any interest in the property.

## *Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and Others* (cont'd)

- The lack of intent to defraud was further shown by:
  - the time lag of 7 months between the summary judgment and the scheme; and
  - the belief (which he found to be genuine) that Elimor's claim was exaggerated and that the company had sufficient fund to meet the claim.
- The breach of fiduciary duty claims fell with the s. 60 claim.

## *Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and Others* (cont'd)

- CA reversed the trial judge's decision. The directors appealed. The CFA affirmed the CA decision.

- The CFA stated the principle as follows:

> "Where it is **objectively** shown that a disposition of property **unsupported by consideration** is made by a disponor when **insolvent** (or who thereby renders himself insolvent) with the **result** that his creditors (including his future creditors) are clearly subjected at least to a significant risk of being unable to recover their debts in full, such facts ought in virtually every case to be **sufficient** to justify the **inference** of an **intent to defraud** creditors on the disponor's part." Para 88, *per* Ribeiro PJ

## Avoidance of floating charge

- Any floating charge created within 12 months from the commencement of winding up shall be void:
  - unless it is proved that the company immediately after the creation of the charge was solvent; and
  - except to the amount of cash paid to the company at the time of the charge at interest rate of not more than 12%.
- “Cash paid to the company” is strictly interpreted.

## *Re Dream Asia Limited* HCMP 4394/2002

- Lenders paid to the creditors of the Company directly in consideration of a floating charge.
- Held:
  - Not “cash paid to the company”.
  - Floating charge created within 12 months avoided.



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## 4. Directors' and employees' personal liabilities in winding-up

- Statutory duty
  - Submission of verified statement of company's affairs (s. 190 CO)
  - Delivery of property to liquidator (s. 211 CO)
  - Private examination (s.221 CO)
- Common law duty
  - Breach of fiduciary duty
  - Negligence

## Submission of verified statement of company's affairs

- If required by the provisional liquidator or liquidator, **directors or officers** must within 28 days of the appointment of the provisional liquidator or the date of the winding-up order submit to the provisional liquidator or liquidator a verified statement of company's affairs (s. 190(1), (2), (3) CO)
- Matters to be included
  - Particulars of the company's assets, debts and liabilities.
  - Names, addresses and occupations of its creditors, securities held by them, dates when the securities were respectively given.
  - Any other information as the provisional liquidator or liquidator may require.

    (s. 190(1) CO)

## Submission of verified statement of company's affairs (cont'd)

- Duty to attend personal **interviews** and provide information when required by the Official Receiver or provisional liquidator or liquidator (CWUR r. 39(2)).
- After the submission of the statement of affairs, the directors or officers who have made the statement have the duty to attend before the Official Receiver, provisional liquidator or liquidator to answer any questions and give further information relating to the statement of affairs if so required (CWUR r. 41).
- Any director or former director, without reasonable excuse, defaults in complying with s. 190 shall be liable to a **fine** and, for continued default, to a daily default fine (s. 190(5) CO).

## Submission of verified statement of company's affairs (cont'd)

- After a winding-up order is made, the court may order officers of the company to deliver, convey, surrender or transfer any money, property or books and papers in their hands, to which the company is *prima facie* entitled (s. 211 CO).
- The power is delegated to the liquidator (s. 226(c) CO and CWUR r. 67).

## Private examination

- S. 221 CO is a powerful investigative tool for liquidators of a company for them to summon any officer of the company for examination.
- Although the examination is called “private examination”, the answers to the “private examination” could be made public.

## Private examination (cont'd)

- Who can be questioned? S. 221(1) CO provides that:

  "The court may, at any time after the appointment of a provisional liquidator or the making of a winding-up order, summon before it:

  (1) any **officer of the company** or person **known or suspected** to have in his possession any property of the company or supposed to be indebted to the company; or

  (2) any person whom the court **deems capable** of giving information concerning the promotion, formation, trade, dealings, affairs, or property of the company."

## Private examination (cont'd)

- What can be asked and how are the answers given? S. 221(2) CO provides that:

  "The court may examine him on oath concerning the matters aforesaid, either by word of mouth or on written interrogatories, and may reduce his answers to writing and require him to sign them."

  S. 221(3) also provides that:

  "The court may require him to produce any books and papers in his custody or power relating to the company…"

## Uncooperative examinee

- S .221(4) provides that:

  "If any person so summoned, after being tendered a reasonable sum for his expenses, **refuses** to come before the court at the time appointed, not having a lawful impediment (made known to the court at the time of its sitting, and allowed by it), the court may cause him to be **apprehended** and brought before the court for examination."

  CWUR r. 61 also provides that:

  "If the summoned person refuses to answer the questions put to him or produces documents/ property requested under the order, he may be held in **contempt of court**."

## *Re Jumbo Fortune (Hong Kong) Ltd* [2008] HKEC 1062

- The liquidators of the company found out an unrecorded transaction with a third party purchaser for US$900,000, and noted an unexplained fall in the company's turnover for certain period.
- To resolve the above suspicions, the liquidators requested information and documents from the former auditor of the company, on the grounds that:
  - It audited the company's financial statements for the period within which the company was wound up;
  - It assisted the company in filing annual returns to the CR; and
  - The documents filed by the third party purchaser was presented by a company secretary with the same address as that auditor.
- The auditor refused to provide information relating to the third party purchaser contending that they were not property of the company.

## *Re Jumbo Fortune (Hong Kong) Ltd* (cont'd)

- Held:
  - Such documents were documents relating to the affairs of the company.
    - Evidence showed that the third party had acquired a substantial investment of the company without paying the consideration.
  - Also, an auditor is considered an officer of the company under s. 221 CO.
  - Therefore, the court ordered the production of the documents and examination of the auditor by the liquidators.
  - The Court also ordered the creditor to pay the costs of the application.

## Breach of fiduciary duty

- Directors and employees generally owe duty of loyalty to the company:
  - to act in good faith
  - not to profit from his position in the company or place himself in a position of conflict of interest.

- Liquidators may claim against directors or employees personally for breach of fiduciary duty owed to the company for compensation or disgorgement of any profit.

## *Halt Garage (1964) Limited* [1982] 3 ALL ER 1016

- Mr. and Mrs. C were the only directors and shareholders.
- Initially both worked in the Company and drew directors' remuneration.
- Since 1967 Mrs. C became ill and draw remuneration at a reduced rate.
- From 1968, Company became unprofitable and went into liquidation in 1971.
- Liquidators sought to recover sums paid to Mr. and Mrs. C on the ground that they were disguised return of capital.
- Held:
  - sums paid to Mr. C, even though may be high, could not be challenged in absence of fraud or dishonesty;
  - sums paid to Mrs. C, only one-third represented reasonable remuneration. She had to refund the rest.

## Fraudulent trading: s275 CO

- s.275 of the Companies Ordinance:-

  "If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the Official Receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct."

## “Intent to defraud creditors” and “fraudulent purpose”

- *Aktieselskabet Dansk Skibsfinansiering v Brothers & Others* (“*ADS v Brothers*”) FACV 25/1998, [2000] 1 HKLRD
  - The directors of Wheelock Maritime International (“WMI”), procured a loan from ADS for WMI.
  - WMI was subsequently wound-up and could not repay the loan.

## *ADS v Brothers* (cont'd)

- Unsecured creditors ADS claimed that the directors of WMI had been guilty of fraudulent trading, contrary to s. 275 of the Companies Ordinance.
- But the directors of WMI were found to be NOT liable because they were found to honestly (but erroneously) believe that the parent of WMI would provide financial support to WMI.

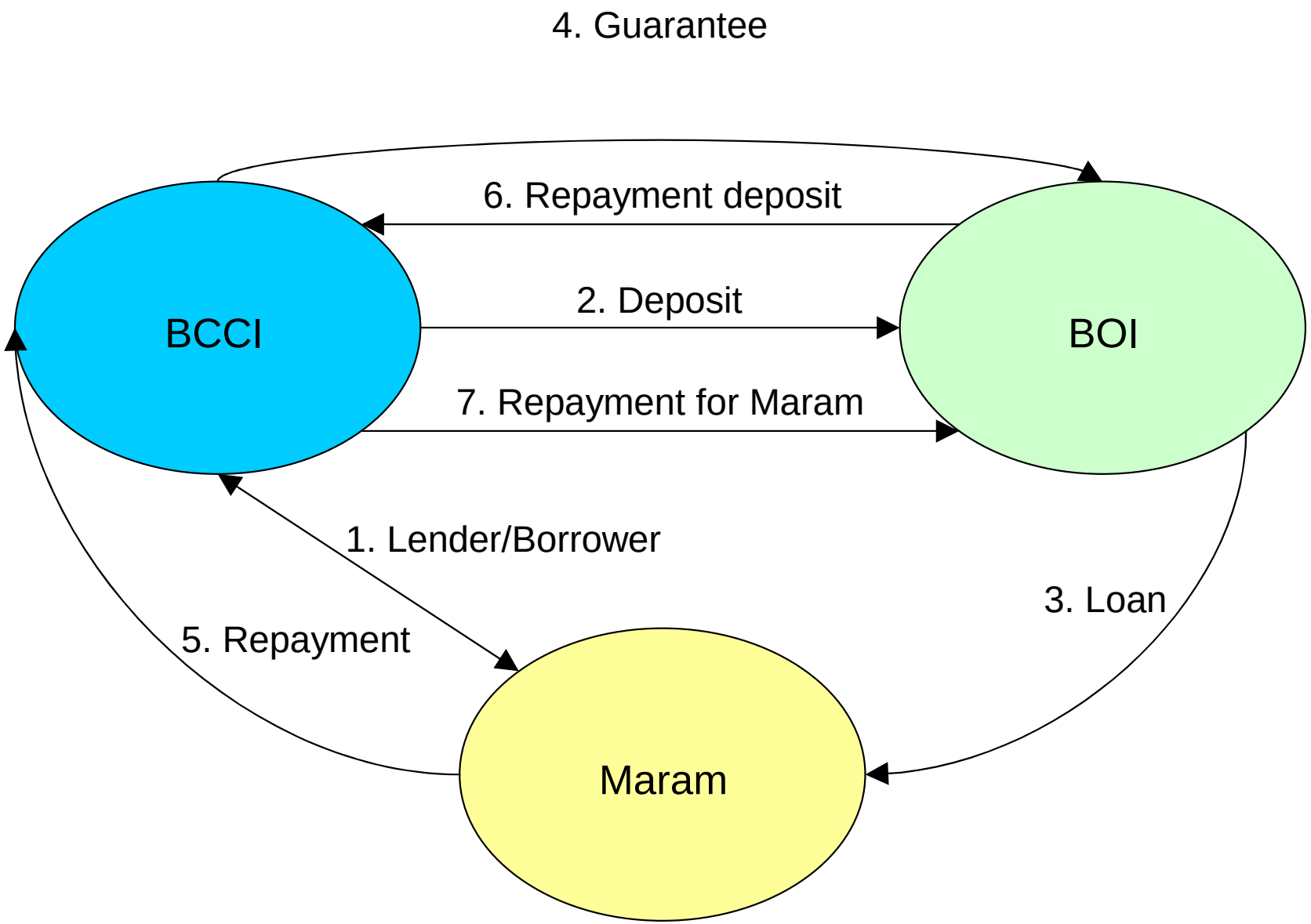
## *ADS v Brothers* (cont'd)

- "Intent to defraud creditors" and "fraudulent purpose"
  - "Fraudulent intent must be established subjectively after a careful examination of all the evidence. Even in what appear to be water-tight cases, fraud may not be found - simply an unjustified albeit honest 'chasing of the rainbow'."

## *Bank of India v Morris* [2005] 2 BCLC 328

The facts:-

- BCCI, a banking group, entered into a series of circular transactions with BOI, an India bank, in order to conceal the losses incurred from the heavily withdrawn accounts of Maram.
- BCCI deposited sums of money with BOI, while BOI lend the same amount of money to Maram at a slightly higher rate.
- BOI benefited from the higher interest rate by lending to Maram.
- The loans from BOI were used to credit the heavily overdrawn accounts of Maram to give the false impression that the indebtedness was being repaid by Maram.


4. Guarantee
6. Repayment deposit
BCCI
2. Deposit
BOI
7. Repayment for Maram
1. Lender/Borrower
3. Loan
5. Repayment
Maram



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## *Bank of India v Morris* (cont'd)

Fraudulent trading:-

- The court found that the businesses of BCCI "has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose".
- The liquidators of BCCI claimed against BOI for being knowingly a party to fraudulent trading by BCCI.

## *Bank of India v Morris* (cont'd)

"Knowingly a party to fraudulent trading":-

- BOI acted through S, its senior manager.
- S's knowledge that the transactions were dishonest sufficed for the purpose of the fraudulent trading provision. It is not necessary to prove that S had a direct intent to defraud BCCI's creditors or he was aware of BCCI's insolvency.
- The judge reached a conclusion as to S's "blind-eye knowledge" at the time of most of the transactions, and upheld the judge's finding of S's dishonesty in the lower court.

## *Bank of India v Morris* (cont'd)

Attribution of individual to corporate knowledge:-

- It was accepted that "outsider" companies could be made liable under the fraudulent trading provision provided that it was shown they were "knowingly" parties to the fraudulent trading.
- The application of the fraudulent trading provision required a special rule of attribution in order to make its self-evident policy effective (para. 95).

## *Bank of India v Morris* (cont'd)

Attribution of individual to corporate knowledge:-

- It could be appropriate to attribute knowledge of fraud to a company, even though:
  - S had acted dishonestly, in breach of his duty to his principal and employer and in circumstances in which he would not have passed on his knowledge to his employer.
  - the members of the board of BOI personally had no knowledge of the fraud, but they were content to leave the conduct and completion of the negotiations in the hands of S.
  - S was acting in breach of his duty to BOI in respect of the transactions with BCCI or that BOI was somewhat a "secondary victim" of his wrongdoing and that of BCCI.

## *Bank of India v Morris* (cont'd)

Attribution of S's knowledge to BOI:-

- S's knowledge of the fraud of BCCI was sufficient to make BOI a party to the fraudulent trading of BCCI.
- S was in substance the relevant decision maker for BOI in respect of the relevant transactions:-
  - He was a senior manager of BOI whose board relied on his judgment in relation to the transactions.
  - He was given "blanket permission" to deal with BCCI by negotiating the terms of the transactions.
  - He was allowed by the board to supervise the relevant transactions with BCCI and ultimately to decide to proceed with them on terms negotiated by him.

## *Bank of India v Morris* (cont'd)

- BOI was held "personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct."
- The loss that BOI has to contribute was loss of BCCI that could be attributed to the fraudulent transactions. The fraudulent transactions helped kept BCCI afloat for longer than it naturally could and suffered more losses than it would otherwise have.
- Taking into account the "contribution" of other parties (e.g. some Swiss banks) and other fraudulent activities of BCCI not related to BOI, the court ordered BOI to contribute $43.231m plus interest.

## Whose interests shall directors safeguard?

- Shareholders' vs creditors' interests
- *Kinsela v Russell Kinsela* (1986) 4 ACLC 215
  - The company in financial difficulties entered into a leasing agreement with its directors at a substantially undervalued rent. The company went into liquidation subsequently.
  - A question arose as to whether (1) such transaction involved a breach of directors' duty and (2) the transaction could be avoided even though it had been approved of by all the shareholders.
  - Held:
    - The interests of creditors intervene on insolvency, so that directors have to have regard to them in exercising their powers in relation to a company's assets.

## *Kinsela v Russell Kinsela* (cont'd)

- Street CJ at 730A-C:

> "In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But **where a company is insolvent the interests of the creditors intrude**. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration."

## *Kinsela v Russell Kinsela* (cont'd)

- The company was plainly insolvent at the date of the lease and its collapse on that ground was imminent.
- The prejudice to the creditors was the direct and calculated result of the lease; its purpose was to place the company's assets beyond the reach of the creditors.
- Based on the above, the court held that the company's challenge was made good.

## *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250

- A director caused the company to transfer a sum of money to its holding company, of which he was also a director, and whose overdraft he had guaranteed, in partial repayment of amounts which it owed to the holding company at a time when both companies were on the verge of liquidation.
- The company subsequently went into liquidation and its liquidator claimed that the director was guilty of misfeasance and breach of duty.
- The director was ordered to repay for the amount paid to the holding company.

## Negligence

- The test:
  - the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as the director in relation to that company (an objective test); and
  - the general knowledge, skill and experience that the director actually has (a subjective test).

(section 465 of the New CO)

# Negligence

Examples of action against directors for negligence:

1. ***Chingtung Futures Ltd (In Liquidation) v Lai Cheuk Kwan Arthur & Ors*** [1992] 2 HKC 637

- Director failed to monitor credit risk of a futures trading account. Customer defaulted causing substantial loss to the company.


2. ***Re D'Jan of London Ltd*** [1994] 1 BCLC 561

- Director negligently filled in insurance proposal form resulting in insurance policy being avoided, company failed to get compensation for a factory destroyed by fire.


- In both cases, both directors were in effective control and ownership of the company. Could they have ratified and forgiven his own negligence?



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## Negligence claims against directors and employees…

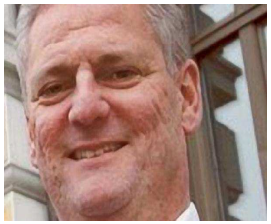
- The claim is not confined to the director whose acts cause direct loss to the company. Directors failing to prevent such acts from happening could be held liable.
- Similar duties apply to employees.

- These are aptly illustrated by the case of *Weavering Capital (UK) Ltd. v. Peterson* [2012] EWHC 1480 (Ch).

## *Weavering Capital (UK) Ltd. v. Peterson* (cont'd)

Fraud,
breach of fiduciary duty

Negligence



**CE/MD**

Investors

$

Advice
and
Manage

**Liquidators**

D1

Couple

**WCF**

OTC
transactions

**Macro**
(in liq)

Public fund

Control
(father and
brother
nominees)

Manager
and
Adviser of
Macro

**WCUK**
(in liq)

WEAVERING
CAPITAL

D2

**Director**

D9

**Director**

D10

**Senior
employee**

Swaps

FRAs



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## *Weavering Capital (UK) Ltd. v. Peterson* (cont'd)

- WCUK set up and managed a public fund called "Macro".
- Macro's Offering Memorandum set out its objectives and strategy which inculde:

- To effect capital appreciation by producing long-term risk adjusted returns by a portfolio of "a balanced and diversified risk profile".
- No more than 20% of the value of the Gross Assets of the Company is exposed to the creditworthiness or solvency of any one counterparty.
- Instruments for investment would be pre-dominantly exchange-traded (as opposed to OTC).




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## *Weavering Capital (UK) Ltd. v. Peterson* (cont'd)

- Facts:
  - D1 Mr. Magnus Peterson – CE and MD of WCUK
  - D2 Mrs. Amanda Peterson – Director, D1's wife, herself an experienced trader
  - D9 Mr. Dabhia – a 27-year-old director with duties including marketing and customer relationship
  - D10 Mr. Platt – a senior employee responsible for compliance and administration

## *Weavering Capital (UK) Ltd. v. Peterson* (cont'd)

- From the beginning, D1 caused Macro to enter into OTC transactions with another (non-public) fund called WCF (set up by D1 with father and brother being nominees) to cover up losses of Macro incurred in exchange-traded transactions.
- In fact, many such transactions were simply shams to make the books of Macro look good.
- In any event, Macro's risk was pre-dominantly skewed to the creditworthiness of WCF (which had little assets).
- Macro appeared to be making steady positive return until it failed to meet redemption requests in the fall of 2008.


THE TI

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Tuesday September 16 2008 timesonline.co.uk No 69430

Lehman collapse sends shockwave round world

hares and oil prices plunge, thousands lose jobs

ry Duncan Economics Editor

Dow Jones industrial average was down 300 points, or 2.6 per



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## *Weavering Capital (UK) Ltd. v. Peterson* (cont'd)

- Macro went into liquidation and its liquidators sued WCUK for breaches of the Investment Advisory Agreement , breaches of fiduciary duty, negligence etc.
- The Investment Agreement provided that:
  - WCUK would indemnify Macro in respect of all losses and liabilities suffered or sustained by Macro resulting or arising in any way from the fraud, negligence or wilful default of WCUK.
- Liquidators of WCUK admitted the claim and then sought reimbursement from the defendants on various grounds including: tort of deceit, breach of fiduciary duties, negligence and dishonest assistance.

## *Weavering Capital (UK) Ltd. v. Peterson* (cont'd)

- D1 held liable for breach of fiduciary duties, negligence, deceit.

- D2 defended that her role in WCUK was confined to exchange traded transactions. The OTC transactions were not carried out by her. And that she was justified in delegating the compliance duties to outside professionals (including auditors EY and the custodian of Macro, PNC Global), other directors and senior employees.

## Director (D2)

- The court took the following factors into account to hold her liable in negligence:
  - she herself was an experienced trader;
  - she was highly paid;
  - the company was relatively small so that everyone knew what everyone else was doing;
  - she knew of and approved at least some irregular OTC transactions;
  - she is to be judged against what a reasonable director should have done in her situation, not what she could have done,

    i.e. subjective factor such as D1 being her husband is irrelevant.
  - **the test** is "*whether D2's conduct was that of a reasonable director of a hedge fund management company in her position who had her experience, actual knowledge and intelligence, and whether she had acquired sufficient knowledge of WCUK's business to discharge her duties*".



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## Director (D9)

- The 27-year-old director.
- His duties include attending meetings with investors and prospective investors to discuss Macro's strategy, holdings and performance, sending out marketing materials and due diligence questionnaires of Macro and dealing with queries from investors.
- Many of his communications with investors concerning the OTC transactions were found to be false and misleading.
- The defence that he was merely passing on the messages of D1 was not sustainable.
    - As director, he failed in his duties by not acquiring sufficient knowledge and understanding of WCUK's business and the details and propriety of the OTC transactions; and taking care in his communications with investors.

## Senior employee (D10)

- D10 was regarded as D1's right-hand man and always followed D1's instructions.
- He sent the trade tickets for the OTC transactions to Macro's Administrator for valuation, and circulated untrue NAV estimates to the investors.
- His bookkeeping for the OTC transactions was flawed and involved backdating, forging of documents and irregularities in documentation for the OTC transactions.

## Senior employee (D10) (cont'd)

Held:

- Even though D10 was not a director and regarded his role as confined to options and futures trading, his duties to WCUK were held to be fiduciary in nature.
- He was highly paid and was entrusted to safeguard the cash and investments under WCUK's management.
  - Therefore, he owed a duty to conduct WCUK's business with due care, skill and diligence.
  - His compliance duty was also incorporated in his employment contract.
- In blindly following D1's instructions in operating the OTC transactions without questions, D10 was held to be negligent.

## Trading while insolvent

- Although there is not yet any legislation on insolvent trading in Hong Kong (unlike in the UK), directors should be aware of the financial status of the company, especially if there are signs that the company has become insolvent.
- Where the directors failed to have regard to the company's financial status and caused the company to enter into certain transactions in breach of their fiduciary duties with losses incurred,
  - The directors can be liable for such losses! *Moulin Global Eyecare Holdings Limited (In Liquidation) & Ors v Olivia Lee Sin Mei* (HCA 167/2008).

## *Moulin Global Eyecare Holdings Limited (In Liquidation) & Ors v Olivia Lee Sin Mei*

- The liquidator claimed against a former non-executive director of the company for breach of fiduciary duty.
  - She failed to have regard to information which should have brought her to the realisation that the company's financial statements had been the subject of serious misreporting.
  - As a consequence, she caused the company to repurchase its own shares, to voluntarily redeem certain convertible notes prior to their due dates and pay out dividends which the company was not in a position to pay and also for the increase in net deficiency of the company.

## *Moulin Global Eyecare Holdings Limited (In Liquidation) & Ors v Olivia Lee Sin Mei*

- The liquidator's claim for the early redemption of convertible notes, repurchases of own shares and also the increase in net deficiency has been struck out as they have only been raised after the limitation period of 6 years has passed and did not arose from facts substantially the same to that already pleaded
- Thus only the Dividend claim remains
- The outcome of the liquidator's claim is still pending, but this is a good wake up call for directors to place their company into liquidation as soon as they realise the company has become insolvent. to avoid personal liability for breach of fiduciary duties.

## Conclusion

Insolvency law may be complicated, but the central lessons are:

- Fair treatment of all creditors
- Directors/managers must act with integrity and reasonable care
- They must have reasonable knowledge commensurate with their positions and duties
- Their duties are owed to the company (meaning the creditors when it is insolvent), not the shareholders
- Extra care should be taken when the company is insolvent – beware of the risk of continued trading whilst insolvent
- They must cooperate with the liquidators
- Seek professional help at first signs of trouble

# Thank you!

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