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A Closer Look at Unfair Preference and Related Claims

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26 Feb 2018

Unfair Preference

Unfair preference is a most commonly used instrument in the Insolvency Practitioners' toolkit. Yet its application is wrought with difficulties and uncertainties, as is illustrated by some recent cases in which the IP's claims were dismissed with costs.

The difficulty arises from a fundamental policy choice between:-

1. Ensuring "fair" treatment of all creditors and pari passu distribution
2. Protecting legitimate commercial transactions from being upset (which may create uncertainties over validity of completed transactions)
3. Promoting a rescue culture





The policy choice was made by a rather elaborate set of rules contained in the BO and CWUMPO, which is centered around the concept of “**desire to prefer**”: -

Transactions undertaken within the twilight period (6 months for all and 2 years for associates, when the company is insolvent) putting a creditor in a preferred position will be set aside if it's entered into by the debtor with a “**desire to prefer**” that creditor.



Note:

1. In some jurisdictions (US and Australia), all transactions within the twilight period will be set aside irrespective of the debtor's mental state.
2. It's arguable if the policy choice has been rightly made. Since 'desire to prefer' could be negated by positive pressure applied by the creditor on the debtor, the law as it stands now encourages creditors to apply pressure and get paid at the first sight of trouble, which is not conducive to corporate rescue (or IVA).
- The mental state of the preferred creditor is **entirely irrelevant** – see Re Stealth Construction Ltd [2011] EWHC 1305 – completely innocent creditor could be found liable to clawback.

Re Stealth Construction Ltd [2011] EWHC 1305

Facts:

- Mrs Ireland lent money to her sister's company on a second mortgage at a time when the company was not insolvent. However, the sister forgot to register it until about one year prior to winding-up, when the company had become insolvent.

Held:

1. The desire to prefer was to be assessed at the time when the debtor decided to enter into transaction, NOT the time of actual transaction.
2. However, if there was a long time lag, the debtor would be taken to have made a second decision at the time of the actual transaction.
3. Mrs Ireland was completely innocent. Yet she was not able to rebut the presumption and found liable for unfair preference.



Subjective mental state is notoriously difficult to define, not to say prove.

Since the IP, in order to invoke the unfair preference provisions, need to establish the debtor's 'desire to prefer', which is a subjective mental state, the claim is often uncertain.

What exactly is meant by 'desire' and how's it different from 'intention'?

This is purportedly explained in a most oft-cited passage by Lord Millet in Re MC Bacon Limited [1990] BCLC 324* :-

*See appendix



Lord Millet's main points are that:-

1. In 1986, the law was changed. The old test (for fraudulent preference) of 'dominant intention' was changed to 'desire to prefer' (for unfair preference).
2. 'Intention' is different from 'desire'.
3. A man usually intends the (foreseeable) consequences of his action, but doesn't necessarily desire such consequences.
4. A debtor who gave a preference to a creditor of course had the intention to do so, but he didn't necessary desire that creditor to be preferred.
5. To establish unfair preference, it's sufficient that the desire was one of the factors influencing the debtor's mind, not the sole, or even balance-tipping factor.

UK Insolvency Act 1986 v. Hong Kong Cap 32

Before proceeding further in our discussion, it's necessary to first clarify some terminology issues. Note the following difference in the wording of the UK and HK statutes:-

UK Insolvency Act 1986		Hong Kong Cap 32	
Section 239(2)	Where the company has at a relevant time (defined in the next section) given a <i>preference</i> to any person, the office-holder may apply to the court for an order under this section.	Section 266(2)	If the company has at a relevant time (within the meaning of section 266B) given an <i>unfair preference</i> to a person, the liquidator may apply to the court for an order under subsection (3).
Section 239(3)	Subject as follows, the court shall, on such an application, make such order as it thinks fit for restoring the position to what it would have been if the company had not given that <i>preference</i> .	Section 266(3)	Subject to section 266C, on an application under subsection (2), the court may make an order that it thinks fit for restoring the position to what it would have been if the company had not given that <i>unfair preference</i> .

See the difference? Any significant implications on the law?

UK Insolvency Act 1986 v. Hong Kong Cap 32

Probably no. See:

UK Insolvency Act 1986		Hong Kong Cap 32	
Section 239(5)	The court shall not make an order under this section in respect of a <i>preference</i> given to any person unless the company which gave the <i>preference</i> was influenced in deciding to give it by a desire to produce in relation to that person the effect mentioned in subsection (4)(b).	Section 266(4)	The court must not make an order under subsection (3) unless the company was influenced, in deciding to give that <i>unfair preference</i> , by a desire to produce in relation to that person the effect mentioned in section 266A(1)(b).

The title of s.239 IA is: Preferences (England and Wales)

The title of s.266, Cap 32 is: Unfair preferences voidable in certain circumstances



Proving a subjective mental state is always not easy. The law assists the IP by:-

- (i) presuming such desire against associates of the debtor,
- (ii) allowing the IP to prove the desire by inference from factual circumstances surrounding the impugned payment.

Application of the Presumption

s.266(5): A company which has given an unfair preference to **a person connected with the company** (otherwise than by reason only of being its employee) at the time the unfair preference was given is **presumed**, unless the contrary is shown, to have been influenced, in deciding to give it, by the desire mentioned in subsection (4).

It should first be noted that the presumption is only in respect of desire, NOT the insolvency of the debtor. The presumption of insolvency only applies against associates in undervalue transactions (s.266B(3)). Hence, the IP still need to establish that the debtor was insolvent at the time of the impugned preference.



'Insolvent' is defined in s.266B(2)*:-

- (2) The time mentioned in subsection (1)(a), (b) or (c) is not a relevant time for the purposes of sections 265D(2) and 266(2) unless either of the following conditions is satisfied—
 - (a) the company is unable to pay its debts (within the meaning of section 178) at that time;
 - (b) the company becomes unable to pay its debts (within the meaning of section 178) in consequence of the transaction or unfair preference.

* note: in the past, we rely on s.51(3) BO, which expressly stipulate the 'balance sheet' test. But s.178, Cap 32, does not expressly stipulate a balance sheet test.



S.51, BO

- (3) For the purposes of subsection (2), a debtor is insolvent if—
 - (a) he is unable to pay his debts as they fall due; or
 - (b) the value of his assets is less than the amount of his liabilities, taking into account his contingent and prospective liabilities.

S.178, Cap 32

178. Definition of inability to pay debts

- (1) A company shall be deemed to be unable to pay its debts—

.....

- (c) if it is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company.



The importance, and difficulty, in proving insolvency is highlighted in the cases of:-

- *Re Ng Shiu Kwan, HCA 311/2014*
- *Re Cheung Siu Kin, HCMP 1431/2012*

Re Ng Shiu Kwan, HCA 311/2014

Facts:

- TIB challenged transfer of 55% shares in a property holding company by husband (bankrupt) to his wife.
- Husband executed declaration of trust in favour of wife for the shares in Nov 2009 (unstamped) purportedly as repayment of loans from wife to husband.
- The actual transfer was made in Oct 2012
- Husband was petitioned bankrupt in May 2013.

Held:

- Although, for purpose of s.49 BO, insolvency of the bankrupt (husband) presumed against the wife, the court found that in 2009, the husband was not insolvent. Action failed.

Re Cheung Siu Kin, HCMP 1431/2012

Facts:

- There're large numbers of to and fro transfers between B and his brother five years prior to bankruptcy.
- TIB claimed that (i) the transfers from brother to B were gifts, when B gave back the money to brother, they were caught by s.49, or (ii) the transfers from brother to B were loans or money entrusted to B for investment, when B gave back the money to brother, they were unfair preferences.
- Brother defended that (i) the transfers to B were money for investment and brother was entitled in trust to a proprietary claim, or (ii) the transfers to B were loan, when B gave back they were repayments – they were made mostly when B was not insolvent and there's no desire to prefer.

Re Cheung Siu Kin, HCMP 1431/2012

Held:-

- The TIB's claim of mutual gifts was unrealistic*.
- The money transfers from brother to B were mostly for investment, but there's no proprietary claim.
- Transfers back to brother were made mostly when B was not insolvent. Those made after B became insolvent was not influenced by desire – presumption rebutted. [One main factor in rebutting the presumption was that brother continued to give money to B to help him out financially after the alleged unfair preference.]

*However, see the case of *Re Lam Ying Ho, HCA 653/2011* – A gift of property had been given by father to son. When the son, at verge of bankruptcy, gave it back to the father, it was held to be in breach of s.49, BO.

We've seen that the presumption was rebutted even between husband and wife (Re Ng Shiu Kwan), and brothers (Re Cheung Siu Kin).

There's also the famous case of Dr. Stanley Hau (CACV 234/2004) where threats to cut off blood relationship by a sister and disturbances at his clinic were held sufficient to rebut the presumption of the debtor's desire to prefer his sister.

Phantom Records Limited, HCMP 2770/2003

Yet sometimes the presumption is so strong that a director who had advanced huge sum to the company could be held liable for unfair preference when a relatively small sum was repaid to himself.

Phantom Records Limited, HCMP 2770/2003

Facts:

- In late 1998, Phantom had largely ceased business and laid off most employees.
- In Jan 1999, Hang Seng Life refunded some HK\$350k to Phantom from its retirement scheme.
- Mr. Louey by that time had advanced HK\$5.7m to Phantom but it was left with little assets.
- Mr. Louey and another director signed a cheque to transfer the refund from Hang Seng to himself.

Phantom Records Limited, HCMP 2770/2003

- In Dec 1998, some employees had filed claim against Phantom with Labour Tribunal for around HK\$150k.
- Louey claimed that he thought the claim was without merits/exaggerated and the company should have enough fund to meet it.
- The company was later sold at nominal value and the employee's claim was not satisfied.

Held:

- The court did not accept Louey's explanation. He was found guilty of unfair preference and disqualified as director for 3 years (although he already paid up the employees' claim subsequently).

Sweetmart Garment Works Limited, HCCW 755/2005

And, where the right circumstances existed, an inference of 'desire' could be drawn even against a non-associate:-

Sweetmart Garment Works Limited, HCCW 755/2005

Facts:

- A case concerned with non-associate being preferred.
- Company granted a mortgage over a ship in favour of one creditor - HSH Nordbank AG
- Nordbank had been sending reminders for repayment to company, but other creditors had taken much more concrete actions – demand letters by solicitors, statutory demands, petition for bankruptcy against guarantors/directors.
- The security to Nordbank was not for new money and the relationship with Nordbank would not help the company to escape insolvency.

Sweetmart Garment Works Limited, HCCW 755/2005

Held:

- The court held the circumstances sufficient to infer the desire to prefer Nordbank even without other evidence as to the mental state of the directors.



The issue of ‘desire’ becomes particularly tricky in a three party situation (guaranteed debt), which in fact is quite common, but not much addressed in case law.

A director provided personal guarantee to a lender for a loan to the debtor company. When he caused the company to repay the lender, he’s presumed to be influenced by the desire to prefer himself.

s.266A(1) has made clear that the guarantor could be liable for unfair preference.

- (1) A company gives an unfair preference to a person if—
 - (a) that person is—
 - (i) one of the company’s creditors; or
 - (ii) a surety or guarantor for any of the company’s debts or other liabilities ...



The issue is:

What about the lender who got repaid?

- Q1. Does the liquidator need to show that there's a desire to prefer the lender if he wants to recover from the lender?
- Q2. If the answer to Q1 is yes, can the desire to prefer the lender be inferred from the desire to prefer the director?

Re Agriplant Services Ltd [1997] B.C.C. 842

The case Re Agriplant Services Ltd [1997] B.C.C. 842 suggested that the answers to both questions are in the affirmative.

Facts:

- The company leased plant and equipment from an asset financier, CAF.
- S, a director who was also the company's majority shareholder, guaranteed rental payments under the lease.
- The company got into financial difficulties and S suspended the rental payments. CAF pressed for payment and threatened to repossess the plant.
- Three weeks before the company went into liquidation a payment of £20,000 was made to CAF.
- The liquidators brought proceedings for unfair preference claims against both CAF and S.

Re Agriplant Services Ltd [1997] B.C.C. 842

Held:

- The case against S was relatively straight forward as he's a connected person and desire was presumed. (His evidence that he acted solely under pressure from CAF and wanted to keep the business was rejected.)
- In relation to CAF, judge found that the company was influenced by the requisite desire because it was only by improving CAF's position that S's own position under the guarantee could itself be improved.

A finding that the company was influenced by a desire to prefer the guarantor can apparently therefore ground an inference that it was also influenced by a desire to prefer the principal creditor.

Re Agriplant Services Ltd [1997] B.C.C. 842

Here's what the Jonathan Parker J. said:

- *The evidence in the instant case establishes, and I find, that in making the payment to CAF the company, that is to say Mr Sagar, was influenced by a desire to improve the position both of himself and of CAF on an insolvent liquidation of the company....*
- *Given the inevitability and the imminence of an insolvent liquidation of the company, it was only by improving the position of CAF on an insolvent liquidation of the company that Mr Sagar's own position under his guarantee could itself be improved. Mr Sagar wanted (desired) to reduce the company's debt to CAF; that is to say, to produce in relation to CAF the effect described in s. 239(4)(b) for just that reason. I accordingly find that the requirements of s. 239(5) are also satisfied in relation to CAF.*
- He rejected CAF's submission that the director was purely motivated by the desire to protect himself from the liability under the guarantee and that payment to CAF was but a necessary step and he had no intention/desire to prefer CAF.

Re Agriplant Services Ltd [1997] B.C.C. 842

The HK Court of Appeal in the case of Re Kam Toys & Novelty Manufacturing Ltd, CACV 67/2017, also a three party case in which a director had given personal guarantee, referred to Agriplant but did not apply it against the lender, apparently on the ground that there was no evidence at all regarding the director's mental state around the time of the alleged preference payment.

Counsel for both sides didn't really argue the applicability of Agriplant. Hence it could not be said whether the CA approved it or not.

Re Agriplant Services Ltd [1997] B.C.C. 842

However, academics such as Adrian Walters*, Goode** doubted Agriplant's answers to both questions.

AW and Goode are of the view that the court has power to order lender to clawback without separately proving desire to prefer the lender, once the desire is proved against the guarantor. This is based on the wording of s.266C, Cap 32, in particular (1)(a) and (d) and (2):-

- (1) Without limiting sections 265D(3) and 266(3), an order under either of those sections with respect to ... an unfair preference given by a company, may do one or more of the following—
 - (a) require any property transferred as part of the transaction, or in connection with the giving of the unfair preference, to be vested in the company;

....

*Vulnerable Transactions in Corporate Insolvency (2002 ed)

**Principles of Corporate Insolvency Law (2011 ed)

Re Agriplant Services Ltd [1997] B.C.C. 842

- (d) require a person to pay, in respect of benefits received by that person from the company, any sums to the liquidator that the court may direct;

....

- (2) An order under section 265D(3) or 266(3) may affect the property of, or impose an obligation on, any person **whether or not that person is the person with whom the company entered into the transaction or, as the case may be, the person to whom the unfair preference was given.**

Re Agriplant Services Ltd [1997] B.C.C. 842

Section 266C(3) seems to provide some protection to innocent third party, but not the lender who received the payment:

- (3) Despite subsection (2)—
 - (a) the order must not prejudice—
 - (i) any interest in property which was acquired **from a person other than the company** and was acquired in good faith and for value; or
 - (ii) any interest deriving from such an interest; and
 - (b) the order must not require a person who received a benefit from the transaction or unfair preference in good faith and for value to pay a sum to the liquidator, **except where that person was a party to the transaction or the payment is to be in respect of an unfair preference given to that person at a time when that person was a creditor of the company.**



In fact, it is submitted (by me) that the wording of s.266C(3)(a) and (b) made it highly arguable that the good faith of the lender is NOT a relevant consideration in whether the court should make the clawback order and the court should make such a clawback order irrespective of the lender's good faith.

The judge and counsel in Agriplant seems to have overlooked these provisions.

No other HK cases, so far, have discussed these provisions.



Finally, it must not be forgotten that a director who caused a company to give an unfair preference could be liable for misfeasance.

More importantly, even if the 'early repayment' falls outside the ambit of the statutory unfair preference scheme (e.g. made more than 6 months before winding up to non-associates), the director could still be liable for breach of fiduciary duty if she was aware of the insolvency of the company at the relevant time. This is confirmed by the CFA in

Moulin Global Eyecare v. Olivia Lee (2014) 17 HKCFAR 466



Conclusion:-

1. To make an unfair preference claim the IP need to establish both insolvency and desire to prefer.
2. The desire to prefer is not always easy to prove. Even in the case of associates, the presumption may be rebutted.
3. Facts and circumstances surrounding the payment must be examined carefully.
4. Though there's no decided case, the provisions of s.266C should be invoked whenever appropriate against lender as well as guarantor.
5. Don't forget the possibility of misfeasance action against directors causing the unfair preference (or even analogous payments).



Thank You!

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