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NOT ALL IS LOST

Recent developments in asset recovery through liquidation

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Outline

This Seminar is not an exhaustive and systematic discussion of all actions to recover assets through liquidation. It merely highlights some recent developments in this area and discuss the more important/interesting recent cases. Topics covered include:-

1. Funding arrangements with liquidators
2. Asset tracing by the liquidators
3. Actions against directors
4. Liabilities of recipients and accessories
5. Liabilities of auditors of a fraudulent corporate vehicle

1. Funding arrangements with liquidators

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Obstacles to litigation funding

- Prohibition against maintenance and champerty

Winnie Lo v HKSAR [2012] HKEC 263, FACC2/2011

- CFA confirmed (again) that champerty and maintenance is still part of HK law and it withstood the unconstitutionality challenge based on lack of certainty
- Yet it also affirmed that lawyers acting for unpaying clients in a worthy case in the hope of recovery at the end and taking the risk of non-payment is “laudable” rather than in breach of professional conduct – however, that does not mean the lawyers can recover anything more than their fees!

HKSAR v. MUI KWOK KEUNG [2013] HKDC 424

- A rare case in which a barrister was convicted of champerty and sentenced to 3.5 years imprisonment for soliciting and entering into champertous agreements with five clients and obtained HK$1.5 m from them as shares of their awards (developing a relationship with the ex-wife of one of the clients along the way!)

- However, in a recent English case, Murray Lewis v Tennants Distribution Limited [2010] EWHC 90161, the English High Court held that it's not champerty for solicitors to agree to shoulder any adverse costs order (but not sharing the award) – there being no evidence that the arrangement would tend to corrupt the administration of justice.

Exclusion to the prohibitions

- Indeed the modern trend is no doubt towards relaxing the restrictions.
- In *Unruh v Seeberger* [2007] 2 HKLRD 414, Ribeiro PJ recognised the law against maintenance and champerty is based on public policy considerations which may vary in time and places and it is now generally recognised that the following categories of exclusions:-

1. "Common interest": where persons with a legitimate interest in the outcome of litigation are justified to support the litigation;
2. "Access to justice": where the support provided to the litigant ensure that those who do not have the resources to fund advocacy or litigation services should be able to obtain these in support of claims which appear to have merit; and
3. A miscellaneous category of practices accepted as lawful, such as:
    - Supplementary legal aid scheme;
    - the sale and assignment by a trustee in bankruptcy of an action commenced in the bankruptcy to a purchaser for value; and
    - the doctrine of subrogation as applied to contracts of insurance.

Lawfulness of litigation funding arrangements in Hong Kong

Unruh v Seeberger [2007] 2 HKLRD 414: held that an agreement in relation to arbitral proceedings in the Netherland which entitled a former director certain special bonus in return for his assistance in the arbitral proceedings was not champertous as the party has a genuine commercial interest in the outcome of the proceedings.

Lawfulness of litigation funding arrangements (cont'd)

- In *Re Cyberworks Audio Video Technology Ltd* [2010] 2 HKLRD 1137, it was held the assignment of a cause of action by a liquidator or a trustee in bankruptcy as part of a funding agreement was an exception to the prohibition on maintenance and champerty and was lawful.

Re Cyberworks Audio Video Technology Ltd [2010] 2 HKLRD 1137.

- The Hong Kong Court for the first time explicitly confirmed in a written judgment the legality of an insolvency litigation funding arrangement that involved the assignment of an insolvent company's right of action to a third party funder.
- Under section 199(2)(a) of the Companies Ordinance, the liquidator has the power to sell the property and choses in action of the company.
- Under section 3 of the Interpretation and General Clauses Ordinance, "property" includes choses in action.
- It was held that a cause of action is a chose in action, so the liquidator is entitled under section 199(2)(a) to sell a cause of action vested in a company.

Qualification to assignment by liquidators(?)

- Such claims that may be assigned by the liquidator would include the recovery of debts, misfeasance actions for breach of fiduciary duty, actions for recovery of assets.
- However, there are English authorities which distinguish such claims from those causes of action that are "vested in the liquidator/trustee", such that claims for unfair preferences under section 266 and recovery of void dispositions under section 182 of the Companies Ordinance are not assignable. (See *Re Oasis Merchandising Services Ltd* [1997] 1 All ER 1009, Lewis v IRC [2001] 3 All ER 499).
- However, in light of the recent HK case of QQ Club Ltd (in Liq) v Golden Year Ltd, HCCW 245/2011 (9 April 2013), these English authorities may not be followed in HK.

- The QQ Club case concerns the issue of whether the costs of a successful unfair preference claim should fall within the meaning of "fees and expenses properly incurred in preserving, realising or getting in the assets [of the company]"
- The question becomes whether recovery under unfair preference claim is "asset of the company". The court said yes. Hence, HK court would depart from the English decision.
- In any event, the liberal attitude towards funding is further illustrated by the following cases.

Geoffrey L. Berman v SPF CDO I, Ltd. and Others HCMP 1321/2010

- This decision has a more far-reaching application as it is not based on a statutory exception (e.g. as under s. 199 of the Companies Ordinance).
- A US company entered into a Chapter 11 liquidation under the U.S. Bankruptcy Code. As part of its restructuring plan the indebtedness due to the Company by two debtors located in Hong Kong was assigned to a trust in favour of the Company's creditors, who in turn assigned the indebtedness to a litigation funder in Hong Kong in order to raise funding to pursue action against the Hong Kong debtors.

Geoffrey L. Berman v SPF CDO I, Ltd. and Others (cont'd)

- The Trustee already obtained approval of the U.S. Bankruptcy Court on the assignment. However, such approval was made conditional upon the Hong Kong court also approving the assignment.
- The Trustee took out an application under O.85 of the Rules of High Court to ask the court for a determination that the Assignment was lawful, or more specifically, that it is not against the Hong Kong law of maintenance and champerty. O.85 gives jurisdiction to the Court to give directions to trustees on questions arising from administration of trusts.

Geoffrey L. Berman v SPF CDO I, Ltd. and Others (cont'd)

- Held:-
- It is clear that the prohibition against maintenance and champerty is still part of the law of Hong Kong.
- However, in recent years, the law about maintenance and champerty has been more refined. Certain arrangements which could be regarded as maintenance or champerty have been held to be lawful provided such arrangements are shown to be promoting the access to justice and otherwise not objectionable on public policy grounds.

Geoffrey L. Berman v SPF CDO I, Ltd. and Others (cont'd)

- In this case, the central question is whether there is a proper commercial purpose to the transaction that gives rise to no risk of the corruption of the judicial and litigation process.
- In addition, the court took into account that the U.S. bankruptcy court has already sanctioned the assignment, and the assignment promoted the access to justice.

Re Po Yuen (To's) Machine Factory Ltd [2012] 2 HKLRD 815

- The frontier was pushed further in this case.
- Harris J sanctioned a funding arrangement for asset recovery (including through litigation) for the liquidator to engage a PRC 'agent' (not a qualified lawyer) under which the agent would be paid on a contingency fee basis (40% of recovery). The agent had to bear all the out-of-pocket expenses.

2. Asset tracing by the liquidators

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Role of liquidators

- Recover and realise the assets of the company.
- Investigate the circumstances surrounding the formation, day-to-day operations of the company.
- Uncover the reasons for the company's failure.
- Adjudicating claims of creditors.
- Payment of dividends out of the company's assets.
- Compliance with various statutory requirements (e.g. report to the Official Receiver on the conduct of the directors for the purpose of disqualification proceedings).

Power of liquidators

- Bring proceedings.
- Engage solicitors.
- Enter into arrangement with third parties who are indebted to the company, or against whom the company has claims.
- Obtain information to support investigations.

Power to obtain information to support investigations

- Where the officers of the company fail to cooperate or the company's account records and documents do not sufficiently reveal the true situation of the company, the liquidator may apply for an examination and/or production of documents pursuant to section 221 of the Companies Ordinance (Cap. 32).

s.221, CO

(1) 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.

(2) The court may require him to produce any books and papers in his custody or power relating to the company, but, where he claims any lien on books or papers produced by him, the production shall be without prejudice to that lien, and the court shall have jurisdiction in the winding up to determine all questions relating to that lien. (Amended L.N. 235 of 1996)

(3) 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.

(4) The court may, at any time after the appointment of a provisional liquidator or the making of a winding-up order, summon before it 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 any person whom the court deems capable of giving information concerning the promotion, formation, trade, dealings, affairs, or property of the company.

Recent Development in Law and Practice of Private examination

- Section 221 of the Companies Ordinance prescribes three categories of persons who may be examined:-
  - any officer of the company;
  - any person who is known or suspected to have in his possession any property of the company or who is supposed to be indebted to the company; or
  - any person whom the court deems capable of giving information concerning the promotion, formation, business, dealings, affairs, or property of the company.

Information which can be obtained

- Section 221 is not limited to reconstituting the state of the company's knowledge.
- It may be used to discover facts and documents relating to specific claims against specific persons which the liquidator has in contemplation.
- The net could be cast very wide: see **RE JUMBO FORTUNE (HONG KONG) LTD [2006] HKCFI 641** – application against co sec of a company suspected to have defrauded the wound-up company.

Abrogation of right against self-incrimination

- Although the privilege against self-incrimination had not been expressly abrogated by section 221, on a true construction of section 221 together with its legislative purpose, it had been impliedly abrogated (*Re Weihong Petroleum Co Ltd* [2002] 1 HKLRD 541; *Re Asher & Co (Hong Kong) Ltd* [2004] 2 HKLRD 37).

Abrogation of right against self-incrimination

- Article 11(2)(g) of the Bill of Rights Ordinance (Cap. 383):

  "In the determination of any criminal charge against him, everyone shall be entitled to the following minimum guarantees, in full equality-

  ...

  (g) not to be compelled to testify against himself or to confess guilt."

- Kwan J in *Re Weihong Petroleum Company* Limited [2002] : The words in article 11(2)(g) are restricted to the rights of a person charged or convicted of a criminal offence.

Abrogation of right against self-incrimination

- If the answers or documents are likely to expose the examinee to criminal prosecution, is he still required to answer?

Hon Kwan J, citing Mann LJ's judgment in *Bishopsgate Investment Management Limited v Maxwell* [1993] Ch 1:-

"The first duties of an office-holder who is a provisional liquidator are to trace and then to secure the assets of the company for the benefit of the creditors and (occasionally) the contributories. His ability to trace in a liquidation where assets are missing and the documentation does not explain their whereabouts, must be heavily dependent upon his ability to use section [s.221]. Those sections could be useless for their purpose if the privilege against self-incrimination is not abrogated."

Subsequent use of information obtained

- Can the examination transcript be used as evidence against the examinee?
  - Section 296(2A) CO: "*any answer given by a person to a question put to him in exercise of powers conferred by rules made under this section may be used in evidence against him*."
    - This section was previously read in *Re Wing Fai Construction Co Ltd* [2006] 4 HKLRD 58, CA to mean that answers given in a private examination can be used against the examinee in civil and criminal proceedings.
    - However, the Court of Final Appeal in *Kennedy v Cheng & Another* [2009] 6 HKC 454 held that transcripts may only be used in criminal proceedings in a derivative manner.

Subsequent use of information obtained

- Can the liquidators release the examination transcript to the police?
  - Rule 62(2) of the Companies (Winding-up) Rules: leave of the court required.
  - *Re Kong Wah Holdings Ltd & Another* HCCW 49 and 50/2000, 25 Sept 07
    - The Liquidators applied for leave to release the private examination transcript to Commercial Crimes Bureau to assist its investigations. It was held not to infringe Human Right.
    - No prohibition against derivative use of materials compulsorily obtained.

Subsequent use of information obtained

- *David John Kennedy v Kelly Cheng* [2009] 6 HKC 454
  - In this case, the liquidator of the company, without leave of the court, disclosed to the police transcripts of the private examinations of the former directors of the company. The examinees sued the liquidator for contempt of court for failing to obtain leave from the court for the above act under rule 62(2) of the Companies (Winding-up) Rules.

  Held (CFA):-

  - no leave is required for a liquidator who reported wrongdoing to the police to supply them with the transcripts of examination.

David John Kennedy v Kelly Cheng (cont'd)

- The purpose of private examination is to enable liquidators to carry out their functions, which include reporting any wrongdoing to the police.
- In so reporting, information obtained from private examination might be disclosed by supplying transcripts of examinations to the authorities.
- Rule 62 does not offer protection of the examinee, but of the liquidation.

Privileged transcripts

- *Akai Holdings Ltd v Ernst & Young* (2009) 12 HKCFAR 649
  - Akai (in liquidation) sued Ernst & Young for negligent audit.
  - During the period between the issuance of the protective writ and the service of the Points of Claim, the liquidators examined a number of people, including former officers and managers of Akai, pursuant to s. 221 CO.
  - Ernst & Young requested Akai to disclose transcripts of s. 221 examinations of former directors and officers.
  - The liquidators refused on the ground that such notes and transcripts were brought into existence in contemplation of litigation (thus, attracting litigation privilege) and for the sole or at least dominant purpose of seeking legal advice (thus, attracting legal advice privilege).
  - The CFA concluded that litigation was in real prospect and that the dominant purpose test was satisfied so as to bring the notes and transcripts under the protection of litigation privilege and shield them from disclosure.

3. Action against Former Directors/Officers

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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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Codification of directors' duty of care, skill and diligence under the new CO

- The test is well-established and will be codified in the new Companies Ordinance in 2014 (tentatively):

- Section 465:

"(1) A director of a company must exercise reasonable care, skill and diligence.

(2) Reasonable care, skill and diligence mean the care, skill and diligence that would be exercised by a reasonably diligent person with –

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

(b) the general knowledge, skill and experience that the director has."

Negligence claims against directors and employees…

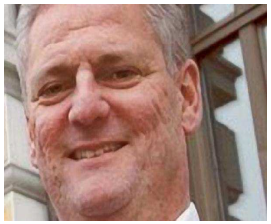
- Note that this is a hybrid test comprising both “objective” and “subjective” standards. This is a strong disincentive for occupying position outside one’s competence.
- The claim is not confined to the director whose acts cause direct loss to the company. Directors failing to prevent such acts from 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)

D2

Director

Manager
and
Adviser of
Macro

WCUK
(in liq)

WEAVERING
CAPITAL

D9

Director

Swaps

FRAs

D10

**Senior
employee**

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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

Max 18C, min 5C

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*".

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.

Some food for thought…

- The cases clearly show that duties of directors and employees are owed to the company, not its controlling director or even sole shareholder, especially when the company is insolvent – this is a counter-intuitive principle overlooked by most employees every day – following the instructions of the controlling director/sole shareholder is NOT a defence to a claim for breach of duties to the company.
- Can the net be cast even wider?
  - What about the Macro's custodian (PNC Global Investment Servicing) who was supposed to provide independent valuation of Marco's investments?
  - What about D1's father and brother who were (nominee) directors and shareholders of WCF? What's the cause of action against them?

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Fraudulent Conveyance (s.60, CPO) and Breach of Fiduciary Duty

- The material part of S.60 of CPO provides as follows:-

  "(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

- One of the most important recent decisions in insolvency
- Judgment handed down on 30th November 2009

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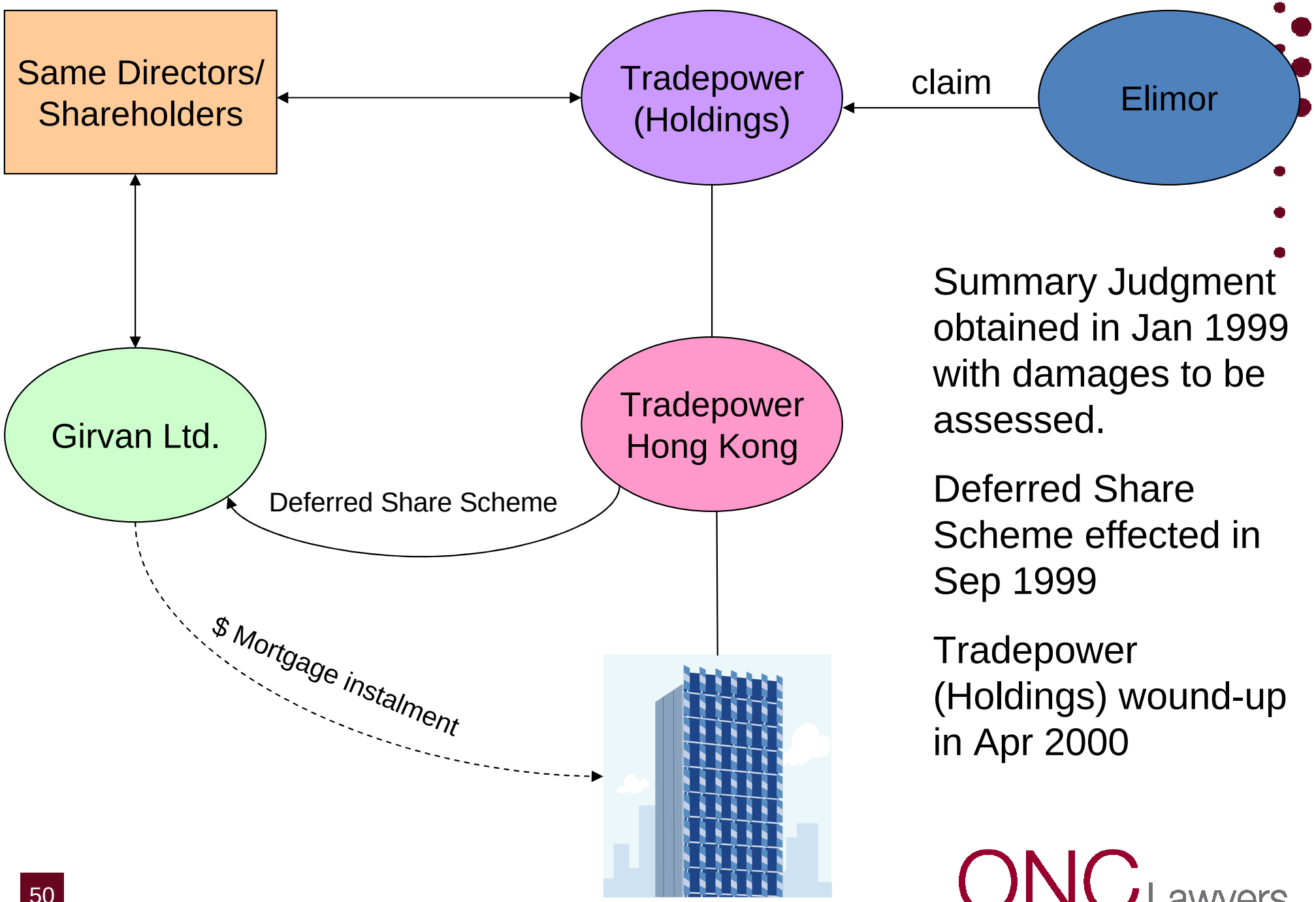
Facts:-



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

- 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

- The trial judge dismissed the liquidators' action:-
  - following the authority of *Lloyds Bank v Marcan*, '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

- the lack of intent to defraud was further shown by:-
  - the time lag of 7 months between the summary judgment and the scheme;
  - 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

- 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*

Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and others

- the word ‘virtually’ is used only because “Never say never is a wise judicial precept” [para 90]
- Hence, for all practical purposes, we could ignore the word.
- The “actual subjective intent” needs only be considered if:-
  a) the company is not insolvent (burden of proof of solvency on the debtor if he was bankrupted shortly afterwards, say, one year); and/or
  b) the disposition is supported by good consideration

Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and others

- The Trial Judge's decision on breach of fiduciary duty is also certainly wrong.
- Breach of fiduciary duty is never dependent on "mens rea" – see ***Regal (Hastings) Ltd v Gulliver*** [1942] UKHL 1, though the existence of "mens rea", if proved, would make the claim much easier.

Fiduciary duty at Insolvency and Unfair Preference

- Action for breaches of fiduciary duties can be used to expand the scope of "unfair preference" claims, as explained in the *Moulin Global Eyecare Holdings Ltd v Olivia Lee Sin Mei* CACV 155/2012 AND CACV 161/2012.
- At present, the statutory unfair preference provisions suffer from the following limitations:-
  - Many related persons do not fall within the definition of "associates" – holding companies, spouse and relatives of directors.
  - The need to prove 'desire to prefer'.
  - The relatively short claw-back periods – 6 months (for non-associates) and 2 years (for associates).

Moulin Global Eyecare Holdings Ltd v Olivia Lee Sin Mei (cont'd)

- One of the claims by the liquidators against the director (Lee) was that she advised on and procured the repayment of certain commercial notes to HSBC at a time when the company was insolvent, thus causing loss to the general body of creditors.
- Liquidators relied on the principles in *West Marcia* and *Kinsela* that at a time when the company is insolvent, the interests of creditors override that of the shareholders and directors' fiduciary duties are owed to the creditors rather than the shareholders.
- Liquidators argued that the company should have stopped trading so that more assets would be available for distribution to general body of creditors.

Moulin Global Eyecare Holdings Ltd v Olivia Lee Sin Mei (cont'd)

"Outside the regime of unfair preference, for a company to seek redress against a director for breach of duty in failing to take account of the interests of creditors, the company would need to bring itself within one of three situations: (a) it has suffered loss; (b) that the director has profited (so that the "no profit" rule operates); or (c) that the transaction in question is not binding on the company …" (per Kwan JA, at para. 27).

Moulin Global Eyecare Holdings Ltd v Olivia Lee Sin Mei (cont'd)

- The early repayments of contract notes were to extinguish genuine liabilities of the company and in discharge of trading liabilities of the company.
- However, there was no resultant depletion of the company's net assets or increase in its net deficiency as a result of the repayments.
- In the absence of **loss** to the company, or profit or benefit to the director, a director is **not** liable to make good an early repayment of contract notes.
- The trial judge's decision was affirmed by the Court of Appeal.

Moulin Global Eyecare Holdings Ltd v Olivia Lee Sin Mei (cont'd)

- Note that it was argued by counsel for the liquidator at the hearing that the purpose of the early repayment was to conceal the fact from the Exchange and public that the company had breached its financial covenants under the loan, and that if not for such concealment, the company would have entered into provisional liquidation much earlier. Hence the director (Lee) was breaching her fiduciary duties in not procuring the early repayment.
- However, Kwan JA did not consider this argument in details as she found that it had not been properly pleaded in the pleadings. It is submitted that there could be some force in the liquidators' argument on this point.

West Mercia Safetywear Ltd v Dodd [1988] BCLC 250

- D was the director of the company and its holding company. D had guaranteed the overdraft of the holding company.
- D caused the company to transfer a sum of money to its holding company in partial repayment of amounts it owed to the holding company.
- At the time of the repayment, 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 and applied for an order that the director repay for the amount paid to the holding company.

West Mercia Safetywear Ltd v Dodd (cont'd)

Held:-

- Once a company was insolvent, the interests of the creditors overrode those of the shareholders.
- The director knew the company was insolvent when he caused the money to be transferred to its holding company.
- The transfer was a fraudulent preference made solely to relieve the director of personal liability under his guarantee in disregard of the interests of the company's creditors.
- The director was guilty of a breach of duty and should be ordered to repay the amount transferred with interest.

- **Note** that this case was decided NOT on the basis of statutory unfair/fraudulent preference, but on general fiduciary duties of directors.

Fiduciary duty at Insolvency and Unfair Preference (cont'd)

- The position seems to be that:-
  - If a payment at the time of insolvency is not caught by the unfair preference provisions, it could still be set aside as an act in breach of fiduciary duty (to the creditors) on the *West Marcia* and *Kinsela* principle.
  - However, unless the directors or their associates somehow benefit from such payment, **normal payment in the ordinary course of business** will not be regarded as breach even if it reduces assets available for distribution.

4. Liabilities of Recipients and Accessories

The Equitable Claim of Dishonest Assistance

- A doctrine developed in equity and trusts to hold liable those assisting a trustee to breach his duties to the beneficiaries.
- Now mainly applied in the corporate and commercial context (as directors are deemed trustee of the company's assets).
- Formerly called "knowing assistance", later changed name and received a boost in application since the landmark case of ***Royal Brunei Airlines v Tan*** [1995] 2 AC 378.

Statement of the doctrine

"A stranger* will be personally liable to account as a constructive trustee to the beneficiaries of a trust for any loss caused to the trust by a breach of trust if the stranger assisted that breach of trust and if the stranger did so dishonestly."**

--- Alastair Hudson, Equity and Trusts (7th ed)

* "stranger" means someone not directly related to the trust.

** "account as a constructive trustee" is merely a fiction for holding the stranger liable. It does not really mean he's a trustee. It's not necessary for him to hold any assets of the trust in order to be liable to account.

Another formulation

"…**First**, a trust or, as here, other fiduciary relationship;

Secondly, a breach of the fiduciary duty on the part of the fiduciary;

Thirdly, a causal link between the breach and a loss to the beneficiaries (or between the breach and a gain to the defendant, as the case may be);

Fourthly, assistance by the defendant in the breach; and

Fifthly a dishonest state of mind on the part of the defendant."

(Weavering Capital (UK) Ltd. v. Peterson at para. 200.)

Royal Brunei Airlines v Tan [1995] 2 AC 378.

- RBA appointed Borneo Travel Limited ("**BTL**") as its travel agent to sell tickets.
- BTL was supposed to keep the sale proceeds separate and remit them to RBA within 30 days. Hence, BTL was trustee of the proceeds for RBA.
- BTL used the money to pay its own expenses and debts and then became insolvent.
- RBA sued the principal shareholder and controlling director of BTL, Tan, on the ground that Tan had assisted BTL to breach the trust.

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Royal Brunei Airlines v Tan (cont'd)

- The trial judge (Denys Roberts, our old CJ) held that Tan had not been fraudulent. He was merely sloppy in running his business.
- Yet, he was liable to RBA for assisting BTL to breach its duty as trustee.
- Tan's knowledge of the trust (and the prohibition to use trust money) made him "dishonest" and rendered him liable as constructive trustee to RBA.
- CA overruled Roberts J.
- Privy Council (led by Lord Nicholls) restored Roberts J's judgment.

Royal Brunei Airlines v Tan (cont'd)

Held (Privy Council):

- The defendant was liable as an accessory.
- The appropriate test of fault was dishonesty with the following considerations:
  - the defendant's knowledge of the circumstances at the time relating to the proposed transaction and his participation in it; and
  - objectively, whether a reasonable person would have considered the defendant's conduct as dishonest taking into account his relevant knowledge.
  - The defendant caused BTL to apply the money in a way that he knew was not authorised. This constitutes a dishonest act.

The Equitable Claim of Dishonest Assistance (cont'd)

- Lord Nicholls emphasized that **the test of honesty is an objective one** i.e. what an honest person in the defendant's circumstances and with his knowledge should have done.
- Some later cases (particularly the HL case of *Twinsectra Ltd v Yardley* [2002] UKHL 12) introduced some uncertainty and seem to suggest that D should be aware that what he did would be regarded as dishonest by ordinary honest people.
- Now authorities seem to be settled, especially in Hong Kong since the *Peconic* case (discussed below), that the test is an objective one.

The Equitable Claim of Dishonest Assistance (cont'd)

- It's important to note that P does not need to prove that D knew the details of the trust or its **breach** by the trustee.
- The test is whether his own conduct in providing assistance to the trustee, in light of what he knew, would be objectively regarded as dishonest (*Barlow Clowes v Eurotrust International* [2005] UKPC 37).

The Equitable Claim of Dishonest Assistance (cont'd)

In *Weavering*, D10 was also sued for dishonest assistance (assisting D1 to breach his fiduciary duties) but he was acquitted of this charge. Why?

"*Having heard Mr Platt over a number of days, my conclusion is that he was simply over-promoted and that he swallowed everything that Mr Peterson told him as to trade customs, compensation, authorisation and the like. He thought, indeed still thinks, that Mr Peterson's explanations made sense, especially as they were not apparently queried by Ernst & Young or by PNC. I do not think he believed that the swaps were not genuine instruments or that his statements to PNC were false. He was given too much to do and did it unquestioningly*.

However, although not fraudulent within the Twinsectra test, Mr Platt was in my judgment plainly negligent. It was an implied term of his contract with WCUK that he would perform his duties with proper care: see e.g. Lister v. Romford Ice and Cold Storage Co Ltd [1957] AC 555 at 572."

The Equitable Claim of Dishonest Assistance (cont'd)

- In *Weavering*, D1's father and brother, who were directors of WCF, which was used to carried out OTC transactions to defraud the investors of Macro, could be sued for dishonest assistance.
- Their liability would depend on their state of mind – to what extent they were aware of D1's fraudulent scheme.
- Note that **"blind eye knowledge"** could constitute dishonesty:

  "*… an honest person does not participate in a transaction if he knows it involves a misapplication of trust assets to the detriment of the beneficiaries. Nor does an honest person in such a case deliberately close his eyes and ears, or deliberately not ask questions, lest he learn something he would rather not know, and then proceed regardless….*" Per Lord Nicholls, *Royal Brunei Air v. Tan* [1995] 2 AC 378.

And don't forget s.275, CO – fraudulent trading and the case of *Bank of India v Morris* [2005] 2 BCLC 328

- s.275 provides:

> "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."

Bank of India v Morris

- The Bank of India was held liable under the English equivalent of s.275 of the CO because it participated, through a senior manager, in a fraudulent scheme orchestrated by the directors of BCCI (a banking group) to boost its book. Thus it was "… knowingly party to the carrying on of the business … [with an intent to defraud or for a fraudulent purpose]…"
- Note that Bank of India was liable even though:
  - It participated through a senior manager, not directors.
  - It did not know of the solvency situation of BCCI.
  - It did not know of the exact purpose of the fraudulent scheme.
  - But it did know that the scheme was commercially pointless and to the detriment of BCCI.

Other types of “Assistance”

- The “assistance” in dishonest assistance can take many forms:

  “*Nor is [liability] limited to those who assist [the trustee] in the original breach. It extends to everyone who consciously assists in the continuing diversion of the money. Most of the cases have been concerned, not with assisting in the original breach, but in covering it up afterwards by helping to launder the money*”

  per Lord Millett, *Twinsectra Ltd v Yardley* [2002] UKHL 12.

Solicitors as dishonest assistants…

- Solicitors involved in the fraudulent transactions involving breaches of fiduciary duties seem to be common targets:

- ***Twinsectra Ltd v Yardley*** : solicitors paid over loan proceeds to borrower disregarding restrictions imposed by lender.
- ***Dubai Aluminium Co Ltd v Salaam***: solicitors helped prepare documentation for a sham consultancy agreement used by fraudster to defraud company.
- And the Hong Kong case of ***Peconic Industrial Development Ltd v Chio Ho Cheong & Others***.

Hong Kong: *Peconic Industrial Development Ltd v Chio Ho Cheong & Others* FACV 17/2008

The main cast:

Agricultural Bank of China: the victim of fraud and majority shareholder of Peconic (the Plaintiff)

Peconic: a JV between ABC and Chio formed for real estate investment in HK

Chio: a Macau businessman and legislative council member, director of Peconic, as well as controller of Asiagreat

Elsie: Chio's girlfriend, a celebrity.

Asiagreat: purchaser of some argicultural land in Mai Po and sub-seller to Peconic

Danny Lau: solicitor for Chio/Elsie handling all the transactions

Elsie Chan

Before

After

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Mai Po Landowners

$151m

Asiagreat

$515m

Sub-sale of the properties at overvalue with secret profits for Chio

Danny Lau

Handling the acquisition transactions

Peconic (JV)

$

$

$

Elsie Chan

Elsie Chan's mother

Leung

… Secret profits channeled back to Chio

$

Chio (director of Peconic)

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Peconic Industrial Development Ltd (cont'd)

- Peconic made claims of dishonest assistance against the following parties:

1. Elsie Chan, the Chio's girlfriend who was alleged to have played a central role in Asiagreat for conducting fraud.
2. Elsie Chan's mother, who handled part of the proceeds of sale under fraudulent scheme so as to conceal the money trail for Chio. Also, she took up appointment of director of the Asiagreat.
3. Leung, common law wife of Chio's brother, who was involved in setting up Asiagreat, being a nominee shareholder of Asiagreat, signed the legal documents as its director to effect the transactions under the scheme, and was involved in the transfer of proceeds of sale from Asiagreat to the director.

Peconic Industrial Development Ltd (cont'd)

4. Danny Lau, the solicitor who handled the transactions (and his solicitors' firms (through vicarious liability)), for assisting the director in misrepresenting the beneficial ownership of the corporate vehicle to JSM (Peconic's conveyancing solicitors), concealing the director's interest Asiagreat and facilitating the director's obtaining massive secret profits in the conveyancing transactions.

- The fraud was committed in 1991/1992
- Actions were commenced against a number of people including Chio, Elsie, her mother and other ‘assistants’ in 1999.
- However, action was somehow not commenced against Danny Lau until 2002.

The test of dishonesty

Per Andrew Cheung J at 184:-

"It is true that strictly speaking these authorities are not binding in Hong Kong. However, I see no reason for not following the latest development of the law by the Privy Council [i.e. ***Royal Brunei Airlines***]…For my part, I prefer the views of **Lord Millett** expressed in *Twinsectra* for the reasons that his Lordship explained in some detail in that case."

- Effectively, the court adopted the **objective** test of dishonesty.

Elsie Chan

- Drove Peconic's PRC investors to the properties for site visit.
- Accompanied Chio to meetings with Peconic's investors.
- Gave instructions to the solicitor in the acquisition transaction.
- Negotiated with landowners for acquisition.
- Entered into commission agreement with the paper owner of Asiagreat.
- Channeled all the proceeds of sale to Chio and his nominees.
- Knew Chio was making the relevant false representations to Peconic's PRC investors as to the development and resale potential of the properties, and the reasonableness of the unit prices of the acquisition.
- On the evidence and application of the objective test of dishonesty, the court found that Elsie Chan was a knowing and willing assistant to Chio's breach of fiduciary duty.

Elsie Chan's mother

- She knew (1) she was assisting Chio in earning money form a dishonest scheme involving Elsie Chan and Chio, and channelling the money so earned to himself or his nominees and (2) the money in question was not at the free disposal of Chio.
- The Court considered the following :
  - her close relationship with Elsie that she must have known the huge sum of money in question could not have been Elsie's money but her boyfriend's money.
  - the huge price difference between the sale and resale transaction that she was involved in as director of Asiagreat.
  - The secretive manner in which the control and ownership of Asiagreat was being concealed.
  - The manner in which money was being channelled out from Asiagreat.
  - She had obtained benefits from her involvement.
  - By applying the objective test, the court found that she was dishonest in rendering assistance to Chio's breach of fiduciary duty.
- It was not necessary that she was actually aware of the fact that Chio was a director in Peconic and he was earning a secret profit in breach of his fiduciary duty. The court adopted what Lord Millett said in Twinsectra that it may be sufficient that the defendant knew she was assisting in a dishonest scheme.

Leung

- By applying the objective test of dishonesty, the court found that:
  - She knew she was helping Chio to receive and channel money to himself that did not belong to him and that he had no right to receive or keep.
  - She knew sufficiently about the transaction to constitute a dishonest state of mind on her part.
  - She must have suspected his so-called commission was unlawful but she shut her eyes and unduly failed to make enquiry.
- It was unnecessary to find that she knew precisely the role of Chio in Peconic.
- Accordingly, Leung was held to be liable for dishonest assistance of Chio's breach of fiduciary duty.

Danny Lau

- As Elsie Chan's solicitor, he assisted in setting up Asiagreat, the fraudulent vehicle for concealing Chio's ultimate ownership and control of the company.
- Lau also took an active role seeking to use Macau cheques for paying deposits to the landowners in order to buy time to wait for the arrival of the huge initial deposit from Peconic's lawyers.
- Lau also caused the paper owner of Asiagreat to give a personal guarantee in relation to the title of the land to conceal the ultimate ownership of Asiagreat.
- Significantly, Lau prepared the legal documents for releasing the sale proceeds to Chio and his nominees, where Lau must have known that Chio was Elsie Chan's boyfriend and Peconic's director, and the huge price difference in the sub-sale that Asiagreat and thus Choi and Elsie Chan were earning.

Danny Lau (cont'd)

- Lau chose to shut his eyes and unduly failed to make enquiry as to his suspicion.
- The CFI held that he was dishonest based on the above and given his assistance in the conveyancing transactions, he was held liable for dishonest assistance.
- However, on appeal to the CA which was affirmed by the CFA, Danny Lau succeeded in his limitation defence under section 20 and 26 of the Limitation Ordinance.

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- The fraud was committed in 1991/1992
- Actions were commenced against a number of people including Chio, Elsie, her mother and other ‘assistants’ in 1999.
- However, action was somehow not commenced against Danny Lau until 2002.

Limitation period of a dishonest assistance action

Peconic's attempt to overcome the limitation defence:-

1. Pursuant to section 20 of the Limitation Ordinance, Peconic argued that there was **no** limitation period to the dishonest assistance claim against Danny Lau.
2. Pursuant to section 26 of the Limitation Ordinance, the limitation period was **postponed** until the date of discovery which was after the six-year period before the second action in 2002, thus the action was not time-barred due to fraud and late discovery of the wrongdoing.

S. 20 Limitation Ordinance

- "(1) **No** period of limitation…shall apply to an action by a beneficiary under a trust, being an action…(a) in respect of any **fraud or fraudulent breach of trust** to which the trustee was a party or privy…"

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S. 26 Limitation Ordinance

- "…where in the case of any action for which a period of limitation is prescribed…(a) the action is based upon the **fraud** of the defendant…the period of limitation shall **not begin** to run **until** the plaintiff has **discovered** the fraud, …or **could with reasonable diligence have discovered** it."

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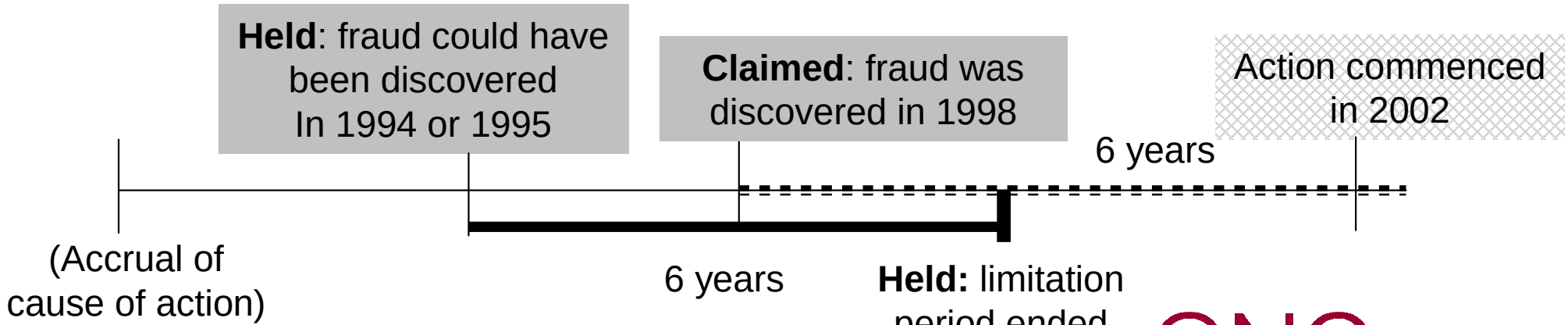
Limitation period of a dishonest assistance action

- The CFA held that first, the six-year limitation period **applies**, as section 20 of the Limitation Ordinance did not apply to Danny Lau who was a **non-fiduciary.** "Trustee" in section 20 does not include a constructive trustee who is a non-fiduciary.
- Second, the beginning of the limitation period was **not postponed until less than six years** (see section 29(2), LO) **before the action was commenced** under section 26, as Peconic could with reasonable diligence have discovered the fraud before the six-year period prior to the commencement of the action against Danny Lau, given all the apparent signs known to Peconic previously.



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Limitation defence: *New China Hong Kong Group Ltd v Ernst & Young* HCCL 41/2004, 2/2005

- This is an action against former auditors and director which was struck out on the ground of limitation period.
- The companies claimed against EY and Anthony Wu for **breach of common law duties** in failing to report various problems to the Companies' management/ the Executive Committee or warn them of the same.
- EY applied to Court to strike out the claims on the ground that the actions were time-barred.

New China Hong Kong Group Ltd v Ernst & Young

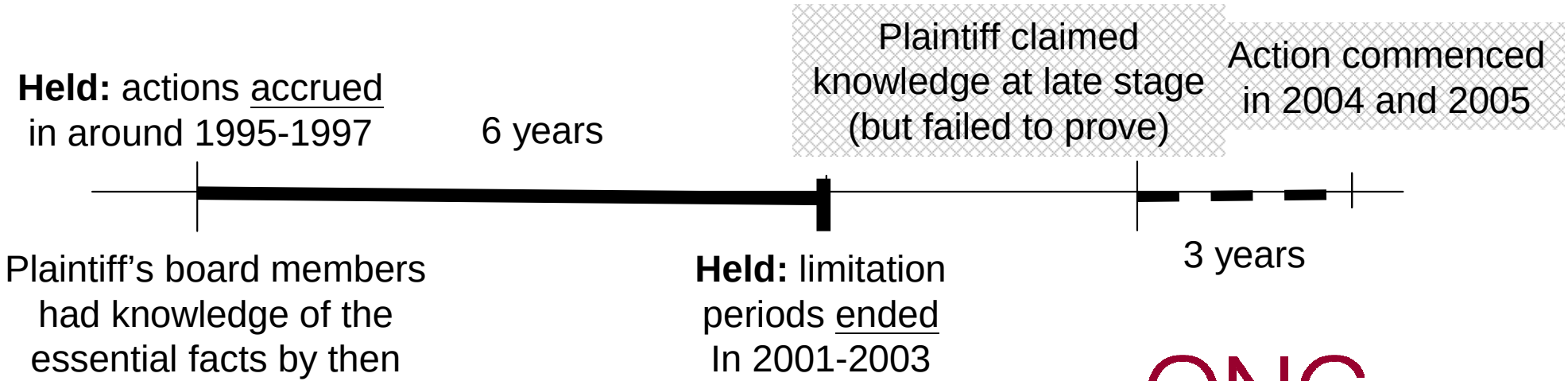
Limitation periods applicable to **negligence claim**:

S. 31 of Limitation Ordinance:

- 6 years from the date of **accrual** of cause of action; or
- 3 years from the date of **knowledge**, if that period expires later.

Limitation defence: *New China Hong Kong Group Ltd v Ernst & Young*

- The companies relied on section 31 LO and contended the causes of action were not **accrued** until the companies' liquidation which is within the time limit.
- The companies argued that the relevant facts were **unknown** to them so as to postpone the running of time until a moment within 3 years of the commencement of the respective actions.
- The above arguments were rejected by the CFI.



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New China Hong Kong Group Ltd v Ernst & Young

Held:

- The independent members of the boards of the Companies (e.g. finance director of the executive committee and common director of the companies) had **knowledge of the essential facts of the claims**.
- By operation of the general rules of attribution, the knowledge acquired by those specifically charged with monitoring the credit positions of the clients should be imputed to the company.

- The causes of action have **accrued** more than 6 years before the commencement of the respective actions against the Defendants.
- The claims were time-barred.

New China Hong Kong Group Ltd v Ernst & Young

- For **breach of fiduciary duty**: although equitable relief was sought for the claims for breach of fiduciary duty, the limitation period of 6 years under s. 4(7) shall apply, as the factual basis and nature of this action is the same as the claims in negligence. Even if such claims were framed as breach of trust, the 6 years limitation period still apply in the absence of fraud in this case.

- The companies were held to have knowledge of all essential facts, and the court held there had been no concealment of facts relevant to their right of action. Therefore, the **postponement** under s. 26 of the Limitation Ordinance did not assist the companies.

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Unconscionable receipt

- Another important equitable cause of action.
- Often used together with unjust enrichment.

- Statement of the Doctrine:

"***Where a person knowingly receives trust property which has been transferred away from the trust or otherwise misapplied, and where that person has acted unconscionably, then that person will incur a personal liability to account as a constructive trustee to the beneficiaries of that trust for the amount of their loss***."

--- Equity and Trusts, Alistair Hudson (7th ed)

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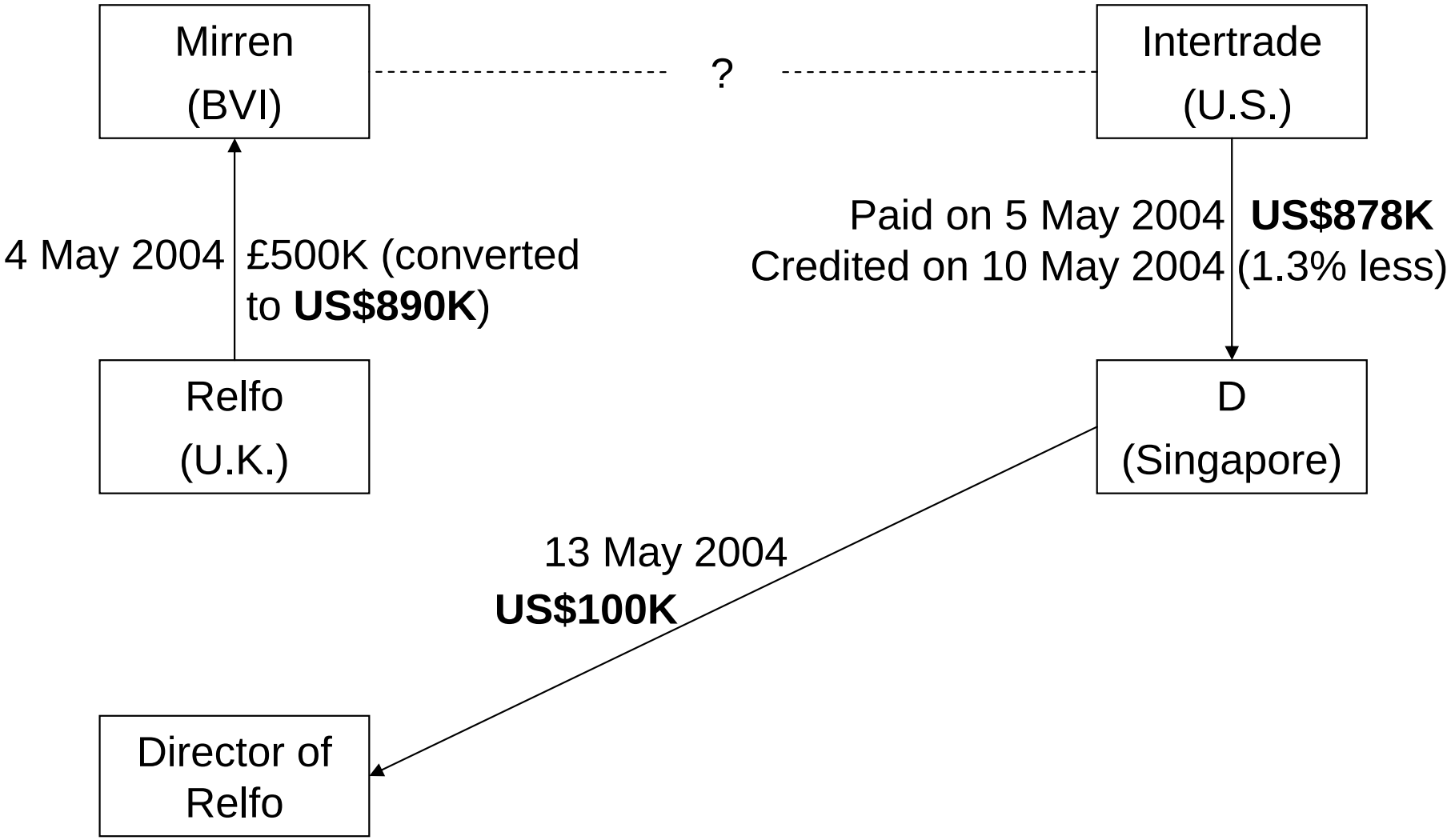
Unconscionable receipt

- It was formerly called “Knowing Receipt”. Again, name changed and given a boost by the case of *BCCI v Akindele* [2001] Ch 437.
- However, Lord Nicholls in *Criterion Properties Plc v Stratford UK Properties LLC* [2004] UKHL 28 opined that *Akindele* was wrongly decided in the context of its facts*.
- Nevertheless, the principles regarding unconscionable receipt propounded in *Akindele* are still widely accepted as authoritative and applied.

*Lord Nicholls was of the view that *Akindele* should be decided on ordinary principles of company and contract law – ie, whether the contract with Akindele was binding on BCCI and that in turn depends on Akindele’s knowledge of the impropriety of the transaction. The same approach was applied by Lord Nicholls in the HK CFA case of *Thai Farmer Bank v Akai* FACV 9/2010

A recent application: *Relfo Ltd v Jadvavarsani* [2012] EWHC 2168 (Ch)



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Relfo Ltd v Jadvavarsani (cont'd)

- Relfo was wound up shortly after the remittance, owing HMRC over $1.4million
- Liquidator of Relfo sued D in Singapore
- Action dismissed as that tantamount to enforcing revenue claim ([2008] SGHC 105])
- Liquidator sued in UK
- The timing and amount of the Relfo/Mirren remittance matched that of the Intertrade/D payment, but the liquidator was not able to establish direct link.
- D gave completely incredible explanations of the remittances.
- Court found that, on balance, what D had received represented proceeds from Relfo.

Relfo Ltd v Jadvavarsani (cont'd)

- What claims could be made by the liquidator?

  (a) Tracing/property claim – what's left in the account of D represented Relfo's property.

  (b) knowing receipt – D knew or had reason to suspect the impropriety of the payment and is liable to account to Relfo.

  (c) Unjust enrichment – D benefited at the expense of Relfo, and that is unjust.

Relfo Ltd v Jadvavarsani (cont'd)

- Held:
  - (a) Failed – D is not a fiduciary of Relfo. Hence court would not make the assumption that money in the account (which mixed D's own money with the Intertrade payment and there had been in and out transactions since receipt of the Intertrade payment) represented Relfo's money. Note that if L was quick enough to get an injunction, this claim could probably succeed.
  - (b) Succeeded – the evidence showed that D was most likely aware of the impropriety of the payment – the breach of duty by Relfo's director. Hence D is liable to account to Relfo.
  - (c) Succeeded – D was clearly enriched. The unjust factor is the lack of consent of Relfo, as the payment was made in breach of its director's duty. This claim has the advantage that D's mind set was irrelevant. But he could raise the change of position defence (which failed in this case).

5. Liabilities of auditors of a fraudulent corporate vehicle

Liquidators' claims against auditors: *Stone & Rolls Limited v Moore Stephens* [2009] UKHL 39

- Claim against auditors by a wound-up company with no innocent directors/shareholders and which perpetrated fraud on creditors/customers.

Stone & Rolls Ltd v Moore Stephens [2009]

- The wound-up company acting through the liquidator sued the former auditors for negligence.
- The company was wholly owned and controlled by a Mr. Stojevic, who through fraudulent L/C transactions, defrauded bank creditors of a total of US$174m.
- The auditors applied to strike out the claim on the ground that (even if they were negligent) they had a complete defence based on the public policy principle that a person cannot bring an action based on his own illegal acts (i.e., the *ex turpi causa* principle).

Stone & Rolls Ltd v Moore Stephens [2009] (cont'd)

- MS argued that as Mr. S was the sole controlling mind and will of the company, his fraudulent knowledge and intent will be attributed to the company, hence the company was the one committing the fraud and it could not maintain the action because of the ex turpi causa principle.
- Auditor's job is to enable company/shareholder to monitor management, he doesn't owe direct duty to outsiders.

Court of Appeal:-

- the company was itself the conduit of fraud, not the victim of fraud, it did not really suffer any loss – no recovery.

Stone & Rolls Ltd v Moore Stephens [2009] (cont'd)

- The House of Lords dismissed the action by the Company by a majority of 3:2.
- the majority upheld the ex turpi causa principle and held that to hold otherwise (in order to help the creditors) would require the extension of the principle in *Caparo v Dickman* [1990] 2 AC 605.

Stone & Rolls Ltd v Moore Stephens [2009] (cont'd)

- The majority pointed out that the principle applied where there was one single dominant director and shareholder, or if there were other directors or shareholders who were subservient to the dominant personality, or where two or more individual directors and shareholders acting closely in concert.
- "However, where innocent shareholders were 'hijacked' by a fraudulent but dominant director, difficult questions arose and the court would have to look closely at the facts to see if it would be contrary to justice and common sense to allow recovery." *per* Lord Walker.

Stone & Rolls Ltd v Moore Stephens [2009] (cont'd)

- The minority expressed the sentiment that to let the auditors go in this situation would significantly weaken the role of auditors as watchdog for the protection of creditors; they questioned that Caparo may be distinguishable as it was not concerned with one-man company situation; moreover, in Caparo, the company involved was not insolvent.
- The minority commented that whilst it is now well established that directors owe duties to creditors when the company is insolvent, why the same could not apply to auditors who are also officers of the company?

Stone & Rolls Ltd v Moore Stephens [2009] (cont'd)

Note the strong dissent of Lords Mance and Scott:-

- Many "Ponzi" style fraud schemes were operated by one man companies and that to absolve auditors from all responsibilities in these circumstances would be questionable policy
- There are well established authorities – Kinsela v Russell, West Mercia v Dodd etc, - which held that when a company is near insolvency, the fiduciary duties of directors are owed to creditors rather than shareholders.
- In such a case, the ex turpi causa should not defeat the claim.

Stone & Rolls Ltd v Moore Stephens [2009] (cont'd)

- The case was criticized by academics who hold that the minority's approach should be preferred. (2009) 24 Australian Journal of Corporate Law, 177; (2010) 126 LQR 14; (2011) 127 LQR 239.
- Professor Eilis Ferran commented that the directing mind and will of Mr. S should not be attributed to the company – the company in the context of the case represented the interests of the creditors, not its shareholder. (2011) 127 LQR 239.
- It remains to be seen whether the principle of ex turpi causa will also bar a claim by a company with innocent independent shareholders or directors to whom the fraud could have been reported

Should HK follow *Stone & Rolls*?

Final words

- This seminar is not an exhaustive discussion of all actions available to liquidators. (There're many others.)
- Funding is now much more liberalized. Actions could be considered even if the wound-up company has no assets.
- The claim for **negligence** is potentially useful and could be used against not just the directors in direct charge, but other 'independent' directors and senior employees who failed to prevent the breach of duties to the company.
- The claim in **dishonest assistance** can much widen the net to cover many more targets (including solicitors!)
- If an unfair preference payment is not caught by the statutory provision, check if a claim in **breach of fiduciary duty** could catch it.
- Be mindful of **limitation periods**!

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