

## INSOLVENCY & RESTRUCTURING

### COVID-19 SPECIAL

# Companies on the brink of insolvency What directors should and should not do to avoid personal liabilities



Produced in partnership with *Ludwig Ng* of *ONC Lawyers*

## Introduction

While many businesses are bracing themselves for the economic slowdown, directors and members of the senior management of a company have to be mindful of their potential liabilities under various statutory provisions should the company go into liquidation. In general, directors and members of the senior management must bear in mind that the company has to pay its employees their wages. They could be held criminally responsible for the company's failure of non-payment. Also, directors and members of the senior management must be careful not to fall foul of the law on fraudulent trading, unfair preference and undervalue transactions, which could result in them shouldering personal liabilities.

## Late payment and non-payment of wages – Insolvency is no defence

Under section 23 of the Employment Ordinance (“EO”), wages shall become due on the expiry of the last day of the wage period and shall be paid as soon as is practicable but in any case not later than 7 days thereafter. Section 63C of the EO makes it an offence if an employer wilfully and without reasonable excuse contravenes section 23. Any director, manager, secretary or other similar officer of the company is guilty of the same offence under s. 64B of the EO if he consents to, connives in or is negligent as to the non-payment of wages.

In *HKSAR v Li Fung Ching Catherine* [2012] HKEC 807, the Court of Final Appeal held that financial difficulty of the company and the desire to restore the company's financial situation by allocating funds to the daily operation of the company did not constitute a reasonable excuse for non-payment of wages. In that case, the director was held liable when she was aware of the fact that wages were not paid and funds were allocated to other matters, and she made no attempts to procure the company to comply with its obligation to pay wages.

## Fraudulent trading

If the business of a company has been carried on with the intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, any persons who is knowingly involved in the carrying on of the business may be personally liable for the debts or other liabilities of the company and be guilty of an offence: please see s. 275 of the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (“CWUMPO”). Anyone who is a party to fraudulent trading can be fined and/or imprisoned. The maximum sentence on indictment is 5 years and the fine is unlimited.

In *Aktieselskabet Dansk Skibsfinansiering v Robert Brothers* [2000] 1 HKLDR 568, the Court of Final Appeal held that whether the person carrying on the business was fraudulent was subjective in the sense that he must personally have been dishonest, and dishonesty in turn must depend upon an assessment of all the facts. “Dishonesty” in this context does not necessarily mean moral deprivation. A director who borrows money or order goods for the company knowing that there is no reasonable prospect to pay the debts when incurred would be regarded as dishonest.

Therefore, where it is clear that there is no reasonable prospect to repay the creditors, it is advisable that the directors and members of the senior management should not procure the company to take on new loans or enter into new contracts for goods/services. Otherwise, the director could be personally liable for such debts. In a serious case of default, the director could even incur criminal liability (see s.275(3), CWUMPO).

## Unfair preference and undervalue transactions

A company gives an unfair preference to a person if (i) the company is going into insolvent liquidation; (ii) that person is one of the company’s creditor, or a surety or a guarantor of the company’s debts or liabilities; (iii) that person is put in a better position than other creditors as a result; and (iv) the company has the desire to put that person in a better position: see ss. 266 and 266A of the CWUMPO. The unfair preferences given are voidable if they fall within the period as stipulated by section 266B of the CWUMPO – 6 months ending with the day of the commencement of winding up in case where the person is not associated with the company and 2 years in case where the person is associated with the company. Importantly for the directors, they could be held personally liable for procuring unfair preferences transactions and responsible for restoring the company to the position it would otherwise have been in.

In *Living the Link Pte Ltd v Tan Lay Tin Tina* [2016] SGHC 67, the High Court of Singapore held that a finding of unfair preference would inevitably lead to the conclusion that the director had breached his fiduciary duty to take into account creditors’ interests when a company is insolvent or nearly insolvency. The Court referred to the English Court of Appeal’s decision in *Liquidator of West Merica Safetywear Ltd v Dodd and another* (1988) BCC 30 in which a director was made personally liable for procuring the unfair preference. More importantly, even if the “early repayment” falls outside the ambit of the statutory unfair preference period (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 he or she was aware of the insolvency of the company at the relevant time. This has been confirmed by the Court of Final Appeal in *Moulin Global Eyecare v Olivia Lee* (2014) 17 HKCFAR 466. Furthermore, directors should be aware that the desire to put a person receiving the unfair preference in a better position will be presumed if that person is associated with the company (s. 266(5), CWUMPO), and a director is a person associated with the company. In *The Official Receiver v James Conrad Louey and another* [2006] HKCFI 1384, the presumption was so strong that the director who had made a substantial loan to the company was held to be liable for unfair preference when he repaid himself a relatively small sum, and he was disqualified as a director for 3 years.

By the same token, it is possible that a director will be held personally liable for undervalue transactions. Undervalue transactions are those (i) that take place when the company goes into liquidation; (ii) that company makes a gift or enters into a transaction for a consideration that is significantly less in value than that provided by the company (ss. 265D and 265E, CWUMPO). Those transactions are voidable if they fall within the period of 5 years ending with the day of the presentation of the winding up petition (s. 266B of the CWUMPO). The only defence is that the company entered into the transaction in good faith and for the purpose of carrying on its business, and there were reasonable grounds for believing that the transaction would benefit the company.

## What directors should do to avoid personal liability

It should be noted that the above is not an exhaustive list of scenarios for directors to incur personal liabilities. The Hong Kong economy is facing unprecedented challenges at the moment. While working hard to overcome the

present adversity, directors and members of the senior management should be aware of their potential liabilities, civil and criminal, under various statutory provisions should the company go into liquidation. When the company is in near insolvency, the proper course is to consult an insolvency law practitioner and consider putting the company into liquidation or implementing other corporate rescue operations under proper advice.

## Author

### Ludwig Ng

Senior Partner, ONC Lawyers

Ludwig's major area of practice is insolvency and corporate restructuring. Under his leadership, the firm has a thriving practice advising and representing insolvency practitioners in Hong Kong and overseas in all aspects of their practice, particularly on investigation of corporate fraud, assets tracing and recovery, actions against former company officers, cross-border insolvency and corporate restructuring. The firm also represents banks, financial institutions and substantial creditors in protecting their rights in the insolvency of their customers. Apart from insolvency, Ludwig is also experienced in the whole spectrum of civil and criminal matters, particularly shareholder disputes, corporate fraud, media law and intellectual properties. Outside the firm, Ludwig is an examiner of the Overseas Lawyers Qualification Examinations. Ludwig is one of the few solicitors in Hong Kong awarded the Higher Rights of Audience, which entitles him to appear as an advocate in all Courts up to the Court of Final Appeal. Ludwig is selected by AsiaLaw Profiles and Chambers and Partners as a leading lawyer in the fields of Dispute Resolution and Restructuring & Insolvency.

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