Insolvency **November 2008**

ONC Lawyers Scores Important Victory For Liquidators

The Court of Appeal re-affirms the directors' duties to a company's creditors in the case of Tradepower Holdings Limited (In Liquidation) v Tradepower (Hong Kong) Limited and others CACV 101/2008 (judgment handed down on 5th November 2008).

Transactions with Intent to Defraud Creditors

Section 60 of the Conveyancing and Property Ordinance ("CPO") provides that the court can set aside any disposition of property (all kinds of property, not just real property) that is undertaken with "intent to defraud creditors". Typically such transactions happen when a company is on the verge of insolvency and on the road to winding up. In such situations, the directors of the company would be tempted to dispose of the assets of the company such that they are out of reach of the creditors, often in favour of themselves or their related parties. Despite the apparent unfairness, there have been few successful challenges to such transactions in the courts by liquidators or creditors of insolvent companies. The reason is the perception that 'intent to defraud creditors' is a subjective test, a high burden that is not easy for the liquidators to overcome. Such high burden, and the way to overcome it, are vividly illustrated by the decisions of the Court of First Instance and the Court of Appeal ("CA") in the Tradepower case, in which ONC Lawyers represented the liquidators and the Plaintiff.

Facts of the Case

In 1997, the Plaintiff ("Holdings") was sued by a creditor ("Elimor") for damages for breach of contract in the sum of over USD900,000. Elimor obtained summary judgment with damages to be assessed. Holdings' appeal against the summary judgment was dismissed in January 1999. A wholly-owned subsidiary of Holdings, TPHK, owned a valuable property. In September 1999, before Elimor's damages could be assessed and enforced, the directors of Holdings put into effect a deferred shares scheme whereby all of Holdings' interest in TPHK was in effect transferred to

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another company controlled by the directors ("GL"). There was some evidence that GL had been helping TPHK to service the mortgage payments for the property. But the actual state of accounts between TPHK and GL was not clear. The audited accounts of TPHK showed that GL, despite assisting in the mortgage payment of TPHK, was indebted to TPHK. What is clear is that TPHK had net asset value and Holdings received no consideration for transferring its interest in TPHK to GL. Holdings was wound up in April 2000. After some investigations by the Official Receiver, an outside liquidator was appointed in 2005 and action was promptly commenced by Holdings against its former directors and GL to set aside the transfer.

Decision of the Court of First Instance

In the Court of First Instance (HCA 1796/2005), the Trial Judge, Recorder Jat Sew Tong SC, dismissed the liquidator's claim. He affirmed that 'intent to defraud' is a subjective test. As GL had been helping TPHK to finance the mortgage without any security from TPHK, the Trial Judge found that the directors of Holdings, who were also directors of GL, had a legitimate reason to be concerned about the interest of GL. He found that when putting into effect the deferred shares scheme, the directors were motivated by their legitimate concern about the interest of GL and were not doing so with intent to defraud the creditors of Holdings. The Trial Judge derived support for his view from the fact that there was a lapse of seven months between the time judgment was obtained against Holdings by Elimor and the putting into effect of the scheme. As to the state of accounts between GL and TPHK, he accepted the 'explanation' of the directors and a staff of TPHK that there were a lot of mistakes therein and they could not be relied upon. He also accepted the evidence of the directors that they believed (subjectively) that the remaining assets in Holdings should be sufficient to cover the claim of Elimor. (There was at most only HK$2 million remaining whilst Elimor's claim was over USD900,000. Yet the directors believed, and the Trial Judge accepted, that Elimor's claim was exaggerated and could be substantially reduced on assessment.)

Decision of the Court of Appeal

If the Trial Judge's judgment were to be upheld, it would create considerable difficulties for liquidators and creditors to bring their section 60 CPO claims. Hence, the Court of Appeal's

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decision to overturn the Trial Judge's judgment is to be welcomed. The CA adopted a quite different, and much more robust, approach than the Trial Judge.

Reliance on Audited Accounts

Firstly, the CA found that the audited accounts of TPHK, which were approved by the directors themselves and unqualified by the auditors, should not be easily dismissed as irrelevant just based on some superficial comments of the directors themselves and the responsible staff. With respect to the Trial Judge, this is a much more sensible and preferred approach. The Trial Judge's finding in this respect is tantamount to holding that the auditors had committed professional misconduct. Very strong evidence would be required for this and the defendants had never put forward such evidence.

Inferring Subjective Intention

Secondly, the CA referred to the classic authority of *Freeman v Pope* (1870) 5 Ch App 538 which states that:

> " … if the necessary effect of [a transaction] was to defeat, hinder, or delay the creditors, that necessary effect was to be considered as evidence of an intention to do so. A jury would undoubtedly be so directed, lest they should fall into the error of speculating as to what was actually passing in the mind of the settlor, which can hardly ever be satisfactorily ascertained, instead of judging of his intention by the necessary consequences of his act, which consequences can always be estimated from the facts of the case …"

Whilst agreeing that the test for "intent to defraud" is a subjective one, the CA is of the view that such subjective intention could be inferred from objective facts, without speculating as to what was passing in the directors' minds. On the facts of the case, the CA found that the inference of "intent to defraud" was simply irresistible. It is noteworthy that the CA so found despite the fact that the Trial Judge had found the directors to be honest in giving their evidence. The CA was not moved by the facts mentioned by the Trial Judge as providing support for a legitimate reason for the scheme and the lack of intent to defraud. To the CA, the facts that the transfer was for no consideration and that creditors subsequently suffered are much more important factors to be taken into account.

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Breach of Directors' Duties

Another regrettable aspect of the Trial Judge's judgment is his failure to deal with the issue of breach of directors' duties. Apart from infringing section 60 of CPO, the directors were in breach of their fiduciary duties to Holdings in putting into effect the deferred shares scheme. This has been pleaded in the Plaintiff's case but was completely ignored by the Trial Judge. Apparently the Trial Judge thought that having a 'legitimate' reason for the transfer would mean that the directors were not in breach of their duties. He was obviously in error.

Conclusion

At this time of financial turmoil, this is a welcome decision of the Court of Appeal. The robust approach adopted by the CA is a boost for creditor protection. And liquidators should not shy away from bringing claims against delinquent directors where appropriate.

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IMPORTANT:
The law and procedure on this subject are very specialized and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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