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## Avoiding personal liability – the do's and don'ts for directors of almost-insolvent companies

For directors, the winding up of a company could be judgment day when their past misdeeds come back to haunt them. If insolvency is on the horizon, there are various matters directors should bear in mind lest incurring personal liability if insolvency becomes inevitable.

### Unfair Preference

The rules governing unfair preference are found under sections 266, 266A, and 266B of the Companies (Winding-Up and Miscellaneous Provisions Ordinance (Cap. 32) (the “**Ordinance**”). A company would be deemed to have given unfair preference to a person if:-

- 1) That person is a creditor of the company, or stands as a surety or guarantor of the company's debts or liabilities;
- 2) That person is, by reason of the action, placed into a better position than he otherwise would be in, if the company goes into liquidation; and
- 3) The company had the desire of placing that person into a better position. Note that if an unfair preference was given to an associate of the company, this desire will become a rebuttable presumption.

If the unfair preference was given (1) to an associate of the company (e.g. director, shadow director or other officer of the company) in the 2 years immediately preceding the date of commencement of winding up, or (2) to a person not associated with the company in the 6 months immediately preceding the date of commencement of winding up, the transaction constituting unfair preference becomes voidable and may be set aside by Court Order to restore the company's position to what it would have been prior to the unfair preference being given.

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A director responsible for causing an unfair prejudice to be given will also be liable for misfeasance. More significantly, even if an unfair preference was given outside the 2 year / 6 months statutory durations, a director may still be liable if he had actual knowledge of the company's insolvency at the time – *Moulin Global Eyecare v Olivia Lee* (2014) 17 HKCFAR 466. When considering whether a company is insolvent, the Court may, as it considers to be appropriate in the circumstances, apply either the "cash flow test" (i.e. whether the company is able to pay debts when they become due) or the "balance sheet test" (i.e. considering the company's assets against its liabilities).

## Undervalue Transactions

The relevant rules under sections 265D, 265E, 266B, 266C, and 266D of the Ordinance define undervalue transactions as either (1) gifts gratuitously given for no consideration in return, or (2) transactions entered into for significantly less than its true value. If an undervalue transaction was entered into in the 5 years immediately preceding the commencement of winding up, and if the transaction was made when the company was insolvent or caused the company to become insolvent, said transaction may be voidable by a Court Order to restore the company's position to what it would have been had the undervalue transaction not been entered into.

As in an unfair preference situation, directors responsible for undervalue transactions may be liable for misfeasance. If however a director is able to prove that the company entered into the transaction in good faith and for the carrying on of the company's business, and there were *reasonable* grounds for believing that the transaction would benefit the company, then the undervalue transaction may be sanctioned by the Court.

## Fraudulent Trading

Pursuant to section 275 of the Ordinance, if a company conducts its business with the intent to defraud the companies' creditors or creditors of any other person, or otherwise for any other fraudulent purpose, all involved persons may become personally liable for the debts and liabilities of the company without limitation. The director (or any other party) may also be subject to an unlimited fine and be imprisoned for a maximum period of 5 years. The director may also be subject to a disqualification order.

The leading case in this area is *Aktieselskabet Dansk Skibsfinansiering v Robert Brothers* [2000] 1 HKLRD 568, where it was confirmed that the test for fraudulent intention was a subjective one. This means that the person carrying on the business must personally have been dishonest.

This high threshold is contrasted with the one for fraudulent dispositions under section 60 of the Conveyancing and Property Ordinance (Cap. 219), which provides that every disposition of property made with the intention to defraud the companies' creditors are voidable.

The Court of Final Appeal in *Tradepower (Holdings) Ltd (In Liquidation) v Tradepower (Hong Kong) Ltd and others* (2009) 12 HKCFAR 417 held that "intention to defraud" is an objective standard within section 60. In other words, it is sufficient to prove that a disposition of property unsupported by consideration is made by a company when insolvent, with the result that the company's creditors are under a significant risk of being unable to recover their debts in full.

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## Payment of wages

In the event of insolvency, employees are amongst the preferred creditors who will receive payments for any unpaid wages. This means that if an insolvent company does not have sufficient funds to meet payments for all unsecured creditors in full, any available funds will be used to satisfy payments to the employees in full before any amount is paid to the general pool of unsecured creditors. Employees may also be entitled to an ex gratia payment out of Hong Kong's Protection of Wages on Insolvency Fund. By the same token, just because the company is entering financial difficulty does not entitle it to withhold, delay, or not pay wages to employees.

Pursuant to section 23 of the Employment Ordinance, wages are payable on the expiry of the last day of the wage period and must be paid within 7 days thereafter. The employer's willful contravention of section 23 without reasonable excuse constitutes an offence, and officers of the company may be guilty of the same offence pursuant to section 64B of the Employment Ordinance if he consents to, connives in, or is negligent as to, the non-payment of wages. The relevant punishment is a fine of HK\$350,000 and imprisonment for 3 years.

The financial difficulty or insolvency of a company is however not a reasonable excuse, as demonstrated in *HKSAR v Li Fung Ching Catherine* [2012] HKEC 807, where a director prioritised other matters to help with the company's financial situation over paying the wages of employees was held to not have a reasonable excuse for the non-payment.

## Keeping of books and records

The duty to keep proper accounting records is found under section 373 of the Companies Ordinance (Cap. 622), and though such a duty does not only become relevant upon the brink of insolvency, any failure on the part of the director to comply with this requirement will be put in the spotlight when insolvency does occur. Under the Ordinance, a disqualification order can be made against the wrongdoing director for failing to keep proper books and records. Further, the Court also has the power to order the company to produce its records and documents for examination.

It is therefore important for directors to comply with the requirement to keep proper accounting records at all times throughout his tenure, and if insolvency appears on the horizon, directors should consider whether the records are complete and up to the standard required. If a company is wound up and it is found that the company has not kept accounting records for any part of either (1) the 2 years immediately preceding the winding up or (2) the period between the incorporation of the company and the commencement of the winding up, whichever is shorter, the director shall be guilty of an offence and liable to imprisonment and a fine.

Similarly, any past or present director of a company being wound up who had, prior to the commencement of winding up, been involved in the destruction, mutilation, alteration or falsification of any company books, papers, or securities, with the intent to deceive any person, shall be guilty of an offence and liable to imprisonment and a fine.

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