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INSOLVENT TRADING – WILL COMPANY DIRECTORS BE EASILY CAUGHT?

Very often, investors would use a Hong Kong limited liability company as a special purpose vehicle (SPV) for investment purposes overseas and appoint their own management team as directors of the SPV. SPVs are governed under the current Hong Kong companies law regime. Unlike some other jurisdictions, Hong Kong does not have any insolvent trading laws whereby directors may face personal liability for preventing a company for trading when the company is insolvent. However, this is about to be changed soon.

DIRECTORS' LIABILITY UNDER THE PROPOSED INSOLVENT TRADING LAWS

It is proposed that insolvent trading laws are to be introduced under a new bill to be presented to the Legislative Council around early 2011. The new bill is expected to be based upon the Companies (Corporate Rescue) Bill ("2001 Bill") presented to the Legislative Council in 2001 which has never been enacted due to the complexity of the legislative proposals. The proposed laws would empower the liquidator to make an application to the court to declare that directors (including shadow directors) are personally liable for those debts incurred by a company after it has become insolvent.

The proposed test for insolvent trading is two-fold:

(1) a director (including a shadow director) knew or ought reasonably know that (a) the company was insolvent or (b) there was no reasonable prospect that the company could avoid becoming insolvent; and

(2) a director (including a shadow director) fails to prevent the company from insolvent trading.

On the face of the test for limb (1) above, if a director ought reasonably know that either the company was insolvent or that there was no reasonable prospect that the company could avoid becoming insolvent, then he is caught. Under the 2001 Bill, the facts which a director ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken by a *reasonably diligent person* having:

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same duties as are discharged by that director in relation to the company; and

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

It would appear that the test is both an objective and a subjective one as the ability and expertise of the particular director is taken into account.

As for limb (2), a director will be caught if he fails to prevent the company from insolvent trading. It is not altogether clear as to the standards required to be met for a director to prevent the company from insolvent trading. Under the 2001 Bill, limb (2) was to the effect that if a director fails *to take any steps* to prevent the company from insolvent trading, then he would be caught. The deletion of the words in italics was a response to the public consultation on the proposed insolvent trading laws. It remains to be seen as to whether there is any further clarifications on this issue under the new bill and as to whether there

would be any exceptions or defence applicable, e.g. that a director took all reasonable steps to stop the company from incurring the debt or to minimize the potential loss of the company's creditors as he ought to have taken.

HOW ARE DIRECTORS AFFECTED BY THE PROPOSED INSOLVENT TRADING LAWS?

The proposed insolvent trading laws would widen the potential personal liability of directors. Under the current law, a court can make a declaration that any persons (including a director) who were knowingly parties to the carrying on of the company's business with intent to defraud creditors of the company or for any fraudulent purpose to be personally responsible for all or any of the debts or other liabilities of the company as the court may direct. In other words, both knowledge and intention are required in order for the director to be personally liable.

Under the proposed laws, company directors found to have failed in their duty to prevent a company trading while being insolvent could be personally liable to pay compensation to the company as the court thinks proper in all the circumstances of the case. Unlike the current law, this does not require the director to be personally involved in the particular trading or to have any fraudulent intention as it suffices if the two limbs of the insolvent trading test are satisfied, i.e. (a) director has actual knowledge or ought reasonably know that the company was insolvent or that there was no reasonable prospect that the company could avoid becoming insolvent and (b) the director's failure to prevent the company from insolvent trading. In other words, a director may face personal liability if he has the knowledge or ought to have known the financial status of the company but nevertheless remains passive in taking any action to prevent the insolvent trading.

WHAT CAN BE DONE?

In view of the proposed insolvent trading laws, it is recommended that company directors, especially those who do not take part in the active management of the company, should take a more active role in the overseeing of the financial status of the company and to notify the board of the company in writing whenever there is any sign of insolvent trading.

While it is generally recognized that the introduction of insolvent trading provisions would encourage directors to act on a company's insolvency earlier rather than later and would enhance corporate governance, clearer guidelines or clarifications should be established for the proposed test for insolvent trading to ease the concern of directors being too easily caught by the insolvent trading provisions.

Hong Kong Office

38/F, Cosco Tower,
183 Queen's Road Central,
Hong Kong

T : (852) 2522 9183
F: (852) 2845 9205
E: vivchan@vcclawservices.com

Beijing Office

Suite 508,
Changan Tower,
10 East Changan Street,
Beijing 100006, China

T : (8610) 6522 7069, 6522 7072
F: (8610) 6522 6967
E: beijing@vcclawservices.com

Shanghai Office

Suite 1002, 10/F,
The Headquarters Building,
168 Central Tibet Road,
Shanghai 200001, China

T: (8610) 6387 9222
F: (8610) 6387 9111
E: shanghai@vcclawservices.com

www.vcclawservices.com