

2000

The New Avoidance Powers under Hong Kong Insolvency Law: A Move from Territoriality to Extaterritoriality

Charles D. Booth

Phillip St. J. Smart

Recommended Citation

Charles D. Booth & Phillip St. J. Smart, *The New Avoidance Powers under Hong Kong Insolvency Law: A Move from Territoriality to Extaterritoriality*, 34 INT'L L. 255 (2000)

<https://scholar.smu.edu/til/vol34/iss1/22>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in International Lawyer by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

The New Avoidance Powers under Hong Kong Insolvency Law: A Move from Territoriality to Extraterritoriality

CHARLES D. BOOTH*
PHILIP ST. J. SMART**

The Hong Kong Bankruptcy Amendment Ordinance of 1996 (B.A.O.) was enacted in December 1996¹ and finally came into operation on April 1, 1998.² The ordinance overhauled Hong Kong bankruptcy law³ for the first time in over a century. It provides for major amendments to the Hong Kong Bankruptcy Ordinance (Bankruptcy Ordinance)⁴ and consequential amendments to other ordinances, including the Hong Kong Companies Ordinance (Companies Ordinance). The changes include substantial amendments to the

*Charles D. Booth (B.A., Yale University, 1981; J.D., Harvard Law School, 1984) is Associate Dean and Associate Professor, Faculty of Law, University of Hong Kong.

**Philip St. J. Smart (LL.B, University of London, 1982; LL.M, University of London, 1983) is Associate Professor, Faculty of Law, University of Hong Kong.

1. See Ordinance 76 of 1996 (Dec. 24, 1996) (H.K.) [hereinafter B.A.O.].

2. See Hong Kong Bankruptcy (Amendment) Ordinance 1996 (76 of 1996) (Commencement) Notice 1998 (L.N. 158 of 1998) (Feb. 20, 1998). In Hong Kong, following the British tradition, it is common for legislation expressly to provide that it is only to come into force upon a date specified by the government in subsidiary legislation. This practice has continued after the resumption of sovereignty over Hong Kong by the People's Republic of China on July 1, 1997. In respect of the B.A.O., the reason for the lengthy delay was that corresponding amendments to the Hong Kong Bankruptcy Rules, cap. 6, sub. leg. A., L.H.K., 1998 (subsidiary legislation dealing with procedural aspects of bankruptcy) were not completed until late 1997. These amendments also came into operation on Apr. 1, 1998; see Hong Kong Bankruptcy (Amendment) Rules 1998 (L.N. 77 of 1998) (Feb. 13, 1998).

3. In Hong Kong, the term "bankruptcy" refers to bankruptcy proceedings involving individuals or partnerships under the Bankruptcy Ordinance, cap. 6, Laws of Hong Kong [hereinafter L.H.K.], 1999. The term "liquidation" refers to liquidation proceedings involving companies under the Companies Ordinance, cap. 32, L.H.K., 1999. In Hong Kong, a liquidation is also called a "winding up."

4. See Charles D. Booth, *Leaping Forward to 1997: Bankruptcy Law Reform in Hong Kong*, 6 INT'L INSOLVENCY REV. 183 (1997) (discussing important changes made by this ordinance).

5. The term "avoidance powers" is used here to refer to those powers conferred by the legislation upon a trustee in a bankruptcy (or a liquidator in a liquidation) to have the court set aside a relevant transaction entered into prior to the commencement of the bankruptcy (or liquidation). The important point to note about such avoidance powers is that the transactions to which they apply could not have been set aside by the debtor at the time they were entered into.

avoidance powers⁵ exercisable by a trustee in a bankruptcy, and a consequential amendment to one of the avoidance powers exercisable by a liquidator in a winding up.⁶ The new avoidance powers are modeled on, and in many parts copied verbatim from, the bankruptcy avoidance powers set out in sections 339 to 343 of the United Kingdom Insolvency Act of 1986 (U.K. Insolvency Act of 1986).⁷ Whereas the old avoidance powers were generally regarded as having only domestic effect and not applying to transactions occurring outside Hong Kong,⁸ recent judicial decisions in England⁹ have held that the relevant U.K. sections (upon which the new Hong Kong provisions are based) do have extraterritorial effect. Thus, one of the likely consequences of the recent amendments is that the new avoidance powers now have extraterritorial effect.

The first part of this article reviews the law regarding the extraterritorial application of Hong Kong's avoidance powers prior to the enactment of the recent amendments. It also discusses the old avoidance powers that were repealed by the B.A.O. The second part considers the position in Hong Kong after the amendments, outlines the new avoidance powers, and discusses the recent English cases that have interpreted the U.K. avoidance powers. The third part recommends that amendments be made to the subsidiary insolvency legislation to enable Hong Kong to fully benefit from the broader reach of the new avoidance powers.

I. The Law Prior to the Enactment of the Bankruptcy Amendment Ordinance of 1996: The Territorial Position

A. BANKRUPTCY

Before the recent bankruptcy amendments, the position in Hong Kong was as follows: section 43(i) of the Bankruptcy Ordinance provided that the property of the debtor divisible among his creditors included "all such property as may belong to or be vested in the bankrupt at the commencement of the bankruptcy or may be acquired by or devolve on him before his discharge."¹⁰ Section 58(1) of the Bankruptcy Ordinance provided that "immediately on a debtor being adjudged bankrupt[,] the property of the bankrupt shall vest in the trustee."¹¹ It was apparent under the old law that these references to property included property outside Hong Kong, because section 2 of the Bankruptcy Ordinance defined "property" as including "money, goods, things in action, land, and every description of property, whether real or personal and whether situated in Hong Kong or elsewhere."¹² Although Hong Kong law provided that a Hong Kong trustee's title extended to property

6. B.A.O., *supra* note 1, at § 76.

7. United Kingdom Insolvency Act, 1986, ch. 45 (U.K.).

8. See American Express International Banking Corp. v. Johnson, [1984] H.K.L.R. 372, 381-82, *discussed in* Charles D. Booth, *The Transnational Aspects of Hong Kong Insolvency Law*, 2 SW. J. L. & TRADE AM. 1, 59-60 (1995).

9. See, e.g., *In re* Paramount Airways Ltd., [1993] Ch. 223, 229 (Eng. 1993).

10. Bankruptcy Ordinance, Description of Bankrupt's Property Divisible Amongst Creditors, § 43(i) (1997) (visited Mar. 25, 2000) <<http://www.justice.gov.hk/home.htm>>.

11. Bankruptcy Ordinance, Vesting and Transfer of Property, § 58(1) (1997) (visited Mar. 25, 2000) <<http://www.justice.gov.hk/home.htm>>.

12. Bankruptcy Ordinance, Interpretation, § 2 (1997) (visited Mar. 25, 2000) <<http://www.justice.gov.hk/home.htm>>.

abroad, whether or not such property in fact vested in a Hong Kong trustee depended on the law of the *lex situs*.¹³ No cases explicitly addressed whether or not the avoidance powers applicable in bankruptcy had extraterritorial effect, but given the absence of any clear language in the relevant provisions, it was generally assumed that the avoidance powers extended only to transactions occurring in Hong Kong.¹⁴

Under the former bankruptcy regime, the two principal avoidance powers exercisable by a trustee were contained in old sections 49 and 47 of the Bankruptcy Ordinance. These sections enabled a trustee to avoid (i) fraudulent preferences (section 49) and (ii) certain settlements made by a debtor (section 47). Pursuant to old section 49, a trustee could avoid as a fraudulent preference, *inter alia*, any payment or transfer of property by a debtor to his creditor that was made:¹⁵

- (a) with the “dominant intention” to prefer the creditor;
- (b) within six months of the filing of the bankruptcy petition;
- (c) at a time when the debtor was unable to pay his debts as they became due.

There was an important exception to this test: a payment or transfer made by a debtor under the fear of legal process or as the consequence of the pressure of a creditor was not considered voluntarily made, and therefore, was not a fraudulent preference.¹⁶ Thus, the old Hong Kong law was most concerned with the debtor’s state of mind in making a payment or transfer. To draw a comparison with U.S. law, rather than preventing “last minute grabs” by creditors as does section 547 of the U.S. Bankruptcy Code,¹⁷ old section 49 in fact encouraged “last minute grabs” by offering strong incentives to creditors to pressure debtors for payment (or to commence execution or attachment against the debtor’s property). The combination of the “dominant intention to prefer” test with the ability of a creditor to overcome the voluntary nature of the debtor’s action led to few fraudulent preference actions being commenced in Hong Kong bankruptcy cases.¹⁸

Old section 47(1) enabled trustees to avoid any settlement of property within two years of the settlor’s bankruptcy, with the exception of settlements “made before and in consideration of marriage, or made in favour of a purchaser or incumbrancer in good faith and for valuable consideration, or . . . made on or for the wife or children of the settlor of property which has accrued to the settlor after marriage in right of his wife . . .”

This test was also applied to settlements made within two and ten years of the debtor’s bankruptcy, with the further exception that a party claiming under the settlement could retain the settlement if he could prove that at the time of the making of the settlement, the settlor was “able to pay all his debts without the aid of the property comprised in the settlement and that the interest of the settlor in such property passed to the trustee of such

13. See 2 DICEY AND MORRIS ON THE CONFLICT OF LAWS 1164, at cmt. to Rule 164, (Lawrence Collins et al., eds., 12th ed., 1993). See also *In Re Chan*, Case No. 88B 10378 (Bankr. S.D.N.Y. 1988) (involving H.K. trustee seeking property abroad).

14. See Booth, *supra* note 8, at 58–59 (discussing generally the extraterritorial reach of the old Hong Kong bankruptcy law).

15. See *Trustee of the Property of Chau Sai Man (Bankrupt) v. Law Chiu*, [1984] H.K.C. 135.

16. See *Sharp v. Jackson* [1899] A.C. 419, applied, e.g., in *Re Kwong Sang Firm*, (1911) 6 H.K.L.R. 113.

17. Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, 92 Stat. 2549 (codified as amended in 11 U.S.C.A. (West 1999), in scattered sections of 28 U.S.C.A. (West 1999), and in scattered sections of other titles).

18. From 1905 to 1999, the law reports in Hong Kong reveal only a handful of cases in which a trustee in bankruptcy successfully pursued a fraudulent preference action.

settlement on the execution thereof.”¹⁹ As can be seen, much of the language in this section is archaic.²⁰ In addition, the most frequently used exception—that the settlement was “made in favour of a purchaser or incumbrancer in good faith and for valuable consideration”—had great potential for causing litigation over whether there was “valuable consideration.”²¹ The upshot was that trustees in Hong Kong rarely exercised this avoidance power.²²

Thus, the overall position prior to the enactment of the B.A.O. was that the avoidance powers not only were not applicable abroad, but in practice were rarely relied upon by a Hong Kong trustee in bankruptcy.

B. LIQUIDATION

The Companies Ordinance is silent as to whether or not a Hong Kong liquidation has extraterritorial jurisdiction. It is clear from the case of *American Express International Banking Corp. v. Johnson*,²³ however, that a Hong Kong liquidator may go abroad to protect the property of a company that is in liquidation in Hong Kong. It is also clear from the liquidation at issue in *American Express*—of Axona International Credit and Commerce Ltd.—that a liquidator may also seek the return of overseas assets so that they may be distributed in the Hong Kong proceedings.²⁴

The *American Express* decision also addressed the issue of whether section 269²⁵ of the Companies Ordinance governed matters involving uncompleted attachments and execu-

19. Bankruptcy Ordinance, § 47(1) (repealed 76 of 1996, § 34) (last visited Mar. 24, 2000) <<http://www.justice.gov.hk/home.htm>>.

20. See *INSOLVENCY LAW AND PRACTICE: REPORT OF THE REVIEW COMMITTEE*, CMND 8558, 278–79 (under the Chairmanship of Sir Kenneth Cork, CBE, 1982).

21. Bankruptcy Ordinance, § 47(1) (repealed 76 of 1996, § 34). See also *Conveyancing and Property Ordinance*, cap. 219, L.H.K., 1999, § 60. (Many of the transactions subject to avoidance under old section 47 could also be attacked as fraudulent conveyances under section 60 of the Hong Kong Conveyancing and Property Ordinance, but avoidance proves difficult under this section as well).

22. Again, the law reports reveal only a few instances in which a trustee in bankruptcy proved successful in avoiding a settlement in Hong Kong.

23. *American Express*, [1984] H.K.L.R. 372.

24. See *In Re Axona Int'l Credit & Commerce Ltd.*, 88 B.R. 597 (Bankr. S.D.N.Y. 1988), *aff'd*, 115 B.R. 442 (S.D.N.Y. 1990), *appeal dismissed*, 92 F.2d 31 (2d Cir. 1991) (explaining that in the U.S. proceedings involving Axona International Credit and Commerce Ltd., the trustee appointed in the United States and the liquidators appointed in Hong Kong filed a joint application requesting that the U.S. bankruptcy court order the turnover of funds in the United States to the Hong Kong liquidators to be distributed in the Hong Kong liquidation proceedings). The request was granted and the funds were later distributed in Hong Kong. See Charles D. Booth, *Recognition of Foreign Bankruptcies: An Analysis and Critique of the Inconsistent Approaches of the United States Courts*, 66 AM. BANKR. L.J. 135, 220–29 (1992) (expounding a detailed discussion of this case).

25. Companies Ordinance section 269(1) provides as follows:

Where a creditor has issued execution against the goods or lands of a company or has attached any debt due to the company, and the company is subsequently wound up, he shall not be entitled to retain the benefit of the execution or attachment against the liquidator in the winding up of the company unless he has completed the execution or attachment before the commencement of the winding up:

Provided that—

... (c) the rights conferred by this subsection on the liquidator may be set aside by the court in favor of the creditor to such extent and subject to such terms as the court may think fit.

Section 269(2), in turn provides that an execution against goods is completed by seizure and sale or by the making of a charging order under section 20 of the Hong Kong High Court Ordinance, ch. 4, L.H.K. (1999) (High Court Ordinance); an attachment of a debt, by receipt of the debt; and an execution against land, by

tions located abroad. Unlike the preference powers that may be used to recover property transferred by the company in the period preceding the commencement of the winding up,²⁶ section 269²⁷ prevents a creditor from *retaining* the benefit of his attachment or execution unless the attachment or execution was completed before the commencement of the winding up.²⁸

In *American Express*, the Hong Kong liquidators had argued that the Companies Ordinance governed attachments in Hong Kong and did not extend to attachments overseas, which were to be governed by the *lex situs*.²⁹ The court was in agreement and noted that:

There is nothing whatever in the Companies Ordinance to suggest that the legislature in Hong Kong, adopting in this respect (with modification) parliamentary legislation from the United Kingdom, was intending any of the words used to extend or operate beyond the jurisdiction of this court. On the contrary, if you look at the words used, all the indications are against it.³⁰

The court observed that the definition of property in section 2 of the Bankruptcy Ordinance expressly applies "to property anywhere," but added "that is the only extended meaning given to any term in the corresponding bankruptcy provisions. So, the direct application of normal principles of construction leads one to the conclusion that this is a domestic code."³¹ Thus, the court held that questions regarding executions and attachments abroad are to be decided by the *lex situs* of the property in question. Moreover, the court added in *obiter* that matters involving preference in insolvency should also be decided by the *lex situs*.³²

Section 266 of the Companies Ordinance provides for the avoidance of fraudulent preferences in corporate insolvencies and, in so doing, incorporates section 49 of the Bankruptcy Ordinance. The Companies Ordinance does not contain an equivalent to old section 47 of the Bankruptcy Ordinance.³³

seizure, by the appointment of a receiver, or by making a charging order under section 20 of the High Court Ordinance.

26. Companies Ordinance, § 266, discussed *infra*.

27. Similar, although not quite identical, rules are applicable to personal insolvencies. See Bankruptcy Ordinance, § 45.

28. See Companies Ordinance, § 269, *supra* note 25. Thus, unlike a "lien creditor" in the United States who is treated as a secured creditor under the U.S. Bankruptcy Code, a creditor in Hong Kong who pursues attachment or execution is treated as an ordinary unsecured creditor until the execution or attachment is completed. 11 U.S.C. § 506(a) (1999). If the creditor does not complete the attachment or execution before the commencement of the winding up, however, the creditor is nevertheless entitled to retain any commencement payments. *In re Andrew*, [1937] Ch. 122, 127 (Eng.). The creditor will lose only the "benefit" of the attachment or execution for the remainder of the debt. *Id.* at 136 (subject to the discretion of the court pursuant to section 269(1)(c)). In contrast, in the United States both the payments to the creditor and the "lien" itself might be subject to avoidance under the U.S. Bankruptcy Code. 11 U.S.C. § 547 (1999).

29. *American Express*, 1984 H.K.L.R. at 381.

30. *Id.* at 384.

31. *Id.* For further discussion of this case, see Booth, *supra* note 8, at 59–60.

32. *American Express*, 1984 H.K.L.R. at 382.

33. Other avoidance powers in the Companies Ordinance are also applicable in corporate insolvencies. For example, section 267 of the Companies Ordinance provides that where a company is being wound up, a charge created as a floating charge by an insolvent company within twelve months of the commencement of the winding up shall be invalid, except to the amount of any cash advanced to the company at the time of (or after the creation of), and in consideration for, the charge, together with interest. The Companies Ordinance does not define the term "floating charge." The noted commentator Professor Roy Goode describes the underlying notion of a floating charge as "that of a class of revolving assets [e.g., inventory] which the company is to be

II. The Law after the Enactment of the Bankruptcy Amendment Ordinance of 1996: The Extraterritorial Position

A. BANKRUPTCY

The definition of property in section 2 of the Bankruptcy Ordinance has not been amended, so references to property in the Bankruptcy Ordinance still include property outside Hong Kong. Pursuant to section 31 of the B.A.O., the former section 43 of the Bankruptcy Ordinance has been repealed. New section 43(1) provides as follows:

Subject to this section and sections 43A to 43E, a bankrupt's estate comprises—(1) all property belonging to or vested in the bankrupt at the commencement of the bankruptcy; and (2) any property which by virtue of any of the provisions of this Ordinance is comprised in that estate or is treated as falling within paragraph (a).³⁴

Section 58 of the Bankruptcy Ordinance has also been retained, so immediately on a debtor being adjudged bankrupt, the property of the debtor continues to vest in the trustee. However, dramatic changes have been made to the avoidance powers applicable in bankruptcy. The first area of reform involves preferences. Old section 49 of the Bankruptcy Ordinance was repealed by section 36 of the B.A.O. and replaced by new sections 50 to 51B of the Bankruptcy Ordinance.³⁵ These new provisions enable a trustee to attack unfair preferences to “associates” of the debtor³⁶ that occur within two years of filing the petition and unfair preferences to nonassociates³⁷ that occur within six months of filing the petition. Under the new set-up, transactions occurring on or after April 1, 1998, are subject to attack by a bankruptcy trustee under the new law.³⁸ New section 50(4) replaces the “dominant intention to prefer” test with a requirement that the debtor be influenced by a “desire” to put a creditor into an improved position in the event of the debtor’s bankruptcy. New section 50(5) in turn, makes it easier for a trustee to attack unfair preferences involving associates; the section provides that an unfair preference by a debtor to an associate (other

free to manage and deal with in the ordinary course of business until an event occurs which entitles the creditor to intervene and assert his security rights over the assets then held or subsequently acquired by the company”). ROY GOODE, *COMMERCIAL LAW* 732 (2d ed. 1995).

In addition, in February 1997, an amendment to the Companies Ordinance took effect that enables a liquidator to seek the avoidance of extortionate credit transactions entered into not more than three years before the commencement of the liquidation. Companies Ordinance, ch. 32, § 264B (enacted pursuant to Hong Kong Companies (Amendment) Ordinance 1997 (Ordinance No. 3 of 1997) (Jan. 16, 1997), § 43).

34. Bankruptcy Ordinance, Definition of Bankrupt's Estate, Ch. 6, § 43 (1999) (visited Mar. 25, 2000) <<http://www.justice.gov.hk/home.htm>>.

35. See B.A.O., *supra* note 1, § 36.

36. As defined in Bankruptcy Ordinance, new section 51B (enacted in B.A.O., *supra* note 1, § 36). Essentially, an “associate” is defined to mean the debtor’s spouse and relatives (and the spouse’s relatives), as well as the debtor’s business, partners or corporations controlled by the debtor or the debtor’s employees.

37. That is, every person who is not an associate of the debtor.

38. See Charles D. Booth & Philip St. J. Smart, *Retroactive or Prospective?: Determining the Applicable Dates of Hong Kong's New Insolvency Law*, 8 INT'L INSOLVENCY REV. 27 (1999) (analyzing applicable dates of the new avoidance powers).

than by reason only of being the debtor's employee) is presumed, unless the contrary is shown, to have been influenced by the debtor's desire to put the associate in an improved position. New section 51(2) provides that for an unfair preference to be avoided, the debtor must be insolvent at the time of transfer or become insolvent as a consequence of the preference.

Pressure by creditors will likely continue to be held sufficient to overcome the voluntary nature of the debtor's actions.³⁹ In addition, payments to creditors may well be found not to have been influenced by a "desire to prefer" but rather by a desire to achieve another purpose.⁴⁰ Thus, the new section will most likely have the greatest impact in attacking transactions involving associates. Nonassociates will still frequently benefit from "last minute grabs."

The second major area of reform involves the mechanism to attack what were called "settlements" under the old law. Old section 47 of the Bankruptcy Ordinance was repealed by section 34 of the B.A.O. and replaced by new section 49 and sections 51 to 51B of the Bankruptcy Ordinance.⁴¹ New section 49 provides for the avoidance of transactions at an undervalue that occur on or after April 1, 1998.⁴² Unlike old section 47, which extended back ten years, new section 49 extends back five years. Section 49 provides that a transaction at an undervalue may involve a gift, a transaction in consideration of marriage, or a transaction in which the transferee's consideration is "significantly less" than the value of the debtor's consideration. The inclusion of a test based on "significantly less" consideration will enable a trustee to avoid the type of challenges that arose under old section 47 involving "valuable consideration." (There are similarities between new section 49 and section 548(a)(2) of the U.S. Bankruptcy Code.)

The section 51(2) requirements are more complicated for transactions at an undervalue than for unfair preferences. For transactions at an undervalue occurring during the two-year period immediately preceding the filing of the bankruptcy petition, the insolvency of the debtor at the time of, or as a result of, the transaction will not be relevant. In contrast, for transactions occurring between two and five years before the presentation of the bankruptcy petition, the requirements mirror those for unfair preferences described above, but also include a presumption of insolvency for any transactions at an undervalue involving an associate (other than by reason only of being the debtor's employee).⁴³

B. LIQUIDATION

Section 76 of the B.A.O. amended the Companies Ordinance through a consequential amendment by adding new section 266B, which is entitled "Fraudulent preference deemed to be an unfair preference." This section provides:

39. This is the position in England, and the Hong Kong provisions have been copied almost word for word from the English legislation. See *In re M.C. Bacon Ltd.*, [1990] B.C.C. 78 (Eng.).

40. See *In re Ledingham-Smith*, [1993] B.C.L.C. 635 (Eng. 1993) (holding that in making a payment to a firm of accountants, the debtor was influenced by a desire to retain the services of the accountants during his financial difficulties).

41. Pursuant to B.A.O., *supra* note 1, § 36.

42. See Booth and Smart, *supra* note 38.

43. In addition, section 44 of the B.A.O. provided for the enactment of a new section 71A of the Bankruptcy Ordinance. This section enables a trustee to seek the avoidance of extortionate credit transactions entered into not more than three years before the commencement of the bankruptcy.

(1) On and after the day section 36 of the Bankruptcy (Amendment) Ordinance 1996 (76 of 1996) (the 'amending Ordinance') comes into operation, where the winding up of a company commences on or after that date—

- (1) a reference in section 266 or 266A of this Ordinance to a fraudulent preference shall be deemed to be a reference to an unfair preference as provided for in section 50; and
- (2) a reference in section 266 of this Ordinance to a period of 6 months shall be deemed to be a reference to a period of—
 - (a) 6 months; or
 - (b) 2 years in the case of a person who is an associate as provided for in section 51B, of the Bankruptcy Ordinance (Cap. 6) (the "principal Ordinance").⁴⁴

Thus, pursuant to section 266B(1), where the winding-up (that is, liquidation) of a company commences on or after April 1, 1998, the new unfair preference terminology will be applicable.⁴⁵ This section applies only to the unfair preference amendments. The B.A.O. amendments regarding transactions at an undervalue are not applicable in corporate liquidations, although it is anticipated that such reforms will eventually be extended to them.⁴⁶

C. EXTRATERRITORIAL EFFECT OF THE ENACTMENT OF THE NEW AVOIDANCE POWERS

As noted above, the new avoidance powers enabling a bankruptcy trustee to attack unfair preferences and transactions at an undervalue are modeled on sections 339 to 342 of the U.K. Insolvency Act of 1986. These sections apply to bankruptcies in England. The related powers applicable in corporate insolvencies in Great Britain are found at sections 238 to 241 of the U.K. Insolvency Act of 1986.

Recent decisions in England reveal that the avoidance powers, upon which the new Hong Kong provisions are based, are extraterritorial in application. For example, in the case of *In Re Paramount Airways Ltd.*,⁴⁷ the Court of Appeal held that section 238, which enables an insolvency representative⁴⁸ to attack a transaction at an undervalue, has extraterritorial effect. In short, the court found that the phrase "any person" in section 238 applies to a person, whether or not a British subject and whether or not resident within the jurisdiction. The Court of Appeal, however, emphasized that it was not bound to make any order and hence retained a discretion not to act to set aside a transaction unless the respondent was "sufficiently connected with England for it to be just and proper to make an order against him"⁴⁹

44. Companies Ordinance, Fraudulent Preference Deemed to Be An Unfair Preference, § 266B (1998) (visited Mar. 25, 2000) <<http://www.justice.gov.hk/home.htm>>.

45. A weakness arises when applying the unfair preference provisions to associates of a corporate debtor. Because of drafting errors, directors, their spouses, and their relatives are generally exempt from the stricter requirements applicable to associates. See Philip Smart, *Unfair Preferences*, H.K. LAW., June 1997, at 15; Philip Smart, *'Associate' Misdefined*, H.K. LAW., Aug. 1997, at 10.

46. The Law Reform Commission of Hong Kong has recommended that such a provision be enacted in the Companies Ordinance. THE LAW REFORM COMMISSION OF HONG KONG, REPORT ON THE WINDING-UP PROVISIONS OF THE COMPANIES ORDINANCE, para. 21.23, at 161 (1999) [hereinafter REPORT ON THE WINDING-UP PROVISIONS].

47. *Paramount Airways*, [1993] Ch. 223, at 239.

48. Which includes a liquidator.

49. *Paramount Airways*, [1993] Ch. 223, at 239. See generally the discussion on the exercise of discretion in PHILIP ST. J. SMART, CROSS-BORDER INSOLVENCY 25-27 (2d ed. 1998).

In addition, although not explicitly raised in the decision, it is clear that the transaction itself may occur outside the jurisdiction.⁵⁰

Commentators in England have accepted *Paramount Airways* as standing for the principle that the English provisions regarding transactions at an undervalue have extraterritorial effect,⁵¹ and at least one has welcomed the development.⁵² Other recent English cases support this interpretation and reveal that unfair preference actions,⁵³ wrongful trading actions⁵⁴ and public examinations⁵⁵ are extraterritorial.⁵⁶

The extent to which English decisional law was binding on Hong Kong courts during the colonial administration is not as simple as it might first appear. Strictly speaking, the only English decisions that bound Hong Kong courts were decisions of the Judicial Committee of the Privy Council that were on appeal from the former Hong Kong Court of Appeal,⁵⁷ but in practice Hong Kong courts regarded Privy Council decisions on appeal from elsewhere binding as well.⁵⁸ In addition, where the question at issue was governed by the common law and the House of Lords had ruled on the matter, the Privy Council and Hong Kong courts considered themselves bound by the decision.⁵⁹ Even though the decisions of most English courts were not strictly binding in Hong Kong, where legislation enacted in Hong Kong had been in substance copied from English provisions, it was highly unusual for the judges in Hong Kong to adopt a different interpretation from that taken in England.⁶⁰ The position after the resumption of sovereignty by the People's Republic of China has not, in practical terms, significantly changed. Article 8 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (Basic Law),⁶¹ Hong Kong's mini-constitution, provides that the laws previously in force in Hong Kong

50. SMART, *supra* note 49, at 17.

51. See, e.g., IAN F. FLETCHER, *THE LAW OF INSOLVENCY* 645 (2d ed. 1996).

52. See Sir Peter Millett, *Cross-Border Insolvency: The Judicial Approach*, 6 INT'L INSOLVENCY REV. 99, 103 (1997).

53. See *Barclays Bank Plc v. Homan*, B.C.L.C. 680, 690 (Eng. 1993).

54. See *In re Howard Holdings Inc.*, B.C.C. 549 (Eng. 1998). Hong Kong law currently does not include an offense of wrongful trading. The Law Reform Commission recently recommended, however, that liability be imposed for the analogous offense of "insolvent trading." THE LAW REFORM COMMISSION OF HONG KONG, REPORT ON CORPORATE RESCUE AND INSOLVENT TRADING, Ch. 19 at 101-129 (1996). At present, in section 275 of the Companies Ordinance, Hong Kong defines only the offense of "fraudulent trading." This section provides that in a winding up, any person who was knowingly party to the carrying on of the business of a company "with intent to defraud creditors of the company or creditors of any other person or for any other fraudulent purpose" may be held personally liable for the company's debts.

55. See *In re Seagull Manufacturing Co. Ltd.*, [1993] Ch. 345 (Eng.).

56. A territorial interpretation continues to apply, however, to the effect of the commencement of a winding up on an uncompleted attachment or execution. See *Re Buckingham International Plc* (No. 1) [1997] 1 B.C.L.C. 681, 687 (Eng.).

57. PETER WESLEY-SMITH, *THE SOURCES OF HONG KONG LAW* 194 (1994) (citing *de Lasala v. de Lasala* [1980] A.C. 546 P.C. H.K.).

58. *Id.* at 193.

59. See *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.* [1986] A.C. 80; see also WESLEY-SMITH, *supra* note 57, at 190-93.

60. See PETER WESLEY-SMITH, *AN INTRODUCTION TO THE HONG KONG LEGAL SYSTEM* 72-73 (2d ed. 1993); but see, e.g., *In re Cirtex Ltd.* [1987] 3 H.K.C. (declining to follow the old English decision in *Re Rica Gold Washing Co.* (1879) 11 Ch. D. 36).

61. The Basic Law is reprinted at 29 I.L.M. 1511 (1990) and can now also be found at <http://www.info.gov.hk/basic_law/english/index.htm>.

shall be maintained, subject to any subsequent amendment by the Hong Kong Special Administrative Region (SAR) legislature.⁶² In addition, it is expressly stated in article 84 that the courts of the Hong Kong SAR “may refer to precedents of other common law jurisdictions.” Thus, English decisions, such as *Paramount Airways*, would undoubtedly be highly persuasive when it comes to the interpretation in Hong Kong of the new avoidance powers.⁶³

It should also be noted that courts in Australia have held that their avoidance powers are not restricted to transactions occurring wholly within the jurisdiction.⁶⁴ Moreover, leaving to one side the case law from other common law jurisdictions, there are, in these commentators’ view, overwhelming policy reasons why the new avoidance powers should be regarded by the Hong Kong courts as operating extraterritorially. To hold otherwise would enable a debtor to deliberately confer a preference upon a creditor resident outside Hong Kong, and the Hong Kong court would be unable to avoid the transaction. The need for an extraterritorial approach to avoidance powers is particularly apparent in Hong Kong because the territory is geographically small⁶⁵ and so much business is conducted either truly internationally or with parties in mainland China.

The issue of the extraterritoriality of the Hong Kong avoidance powers is complicated by the lack of discussion by the Hong Kong policy-makers. Most of the changes enacted in the B.A.O. incorporated the recommendations made by the Law Reform Commission in its 1995 Report on Bankruptcy⁶⁶ and by the Law Reform Commission Sub-Committee on Insolvency in its 1993 Consultative Document on Bankruptcy.⁶⁷ However, neither the Report nor the Consultative Document discussed amendments to the avoidance powers.⁶⁸ Rather, these changes first appeared in the Hong Kong Bankruptcy Amendment Bill of 1996,⁶⁹ which was gazetted after the publication of both the Consultative Document and the Report. It is understood that neither the Law Reform Commission nor the Sub-Committee addressed the issue of the potential extraterritorial application of the avoidance powers.

III. A Practical Problem: The Need to Amend the Hong Kong Insolvency Rules

The net result, assuming that Hong Kong courts continue to follow the reasoning in the English cases, is that the Hong Kong courts will now have considerable extraterritorial

62. The laws previously in force are defined in article 8 as “the common law, rules of equity, ordinances, subordinate legislation and customary law.” *Id.* See YASH GHAI, HONG KONG’S NEW CONSTITUTIONAL ORDER: THE RESUMPTION OF CHINESE SOVEREIGNTY AND THE BASIC LAW 367-69 (2d ed. 1999).

63. After the resumption of sovereignty, no English decision, even of the House of Lords on a question of common law, will bind the new Court of Final Appeal in Hong Kong. See *Tang Siu Man v. HKSAR* [1998] 1 H.K.C. 371, 405.

64. See *In re York Paper Co. Ltd.* [1991] 9 A.C.L.C. 60 (although the Australian provisions are far from identical to the English or Hong Kong provisions).

65. The area of Hong Kong is only 1,095 square kilometers. See HONG KONG—A NEW ERA, Preface (1998).

66. THE LAW REFORM COMMISSION OF HONG KONG, REPORT ON BANKRUPTCY (1995).

67. THE LAW REFORM COMMISSION OF HONG KONG SUB-COMMITTEE ON INSOLVENCY, CONSULTATIVE DOCUMENT ON BANKRUPTCY (1993).

68. Although the more recent REPORT ON THE WINDING-UP PROVISIONS did include a section on avoidance powers, it too was silent as to matters involving extraterritoriality. REPORT ON THE WINDING-UP PROVISIONS, *supra* note 46, Ch. 21, at 157-168.

69. Gazetted Mar. 1, 1996.

powers when conducting bankruptcy and winding-up proceedings. The presence of extra-territorial powers in the new legislation is not a problem. Indeed, given the realities of global business it is a development that should be welcomed by all, except, of course, by bankrupts and their associates. The issue is likely to be far from academic; given the greater effectiveness of the new avoidance powers it is most likely that trustees and liquidators will seek their extraterritorial application. There is a very real problem with the current position, however; namely, the subsidiary legislation has not been amended to reflect the new extra-territorial powers.

In the United Kingdom, to avoid the difficulties that arise where one is seeking to serve process on a person who is beyond the jurisdiction, Rule 12.12(3) of the United Kingdom Insolvency Rules of 1986⁷⁰ was introduced:

Where for the purposes of insolvency proceedings any process or order of the court, or other document, is required to be served on a person who is not in England and Wales, the court may order service to be effected within such time, on such person, at such place and in such manner as it thinks fit. . . .

The position in England, therefore, is that the avoidance powers apply to any person—whether in England or not; and service on such a person can be effected pursuant to U.K. Rule 12.12(3).

In contrast to the clear English position, the situation in Hong Kong is muddled because no provision equivalent to U.K. Rule 12.12(3) has been enacted in either the Hong Kong Bankruptcy Rules (Bankruptcy Rules) or in the Hong Kong Companies (Winding-up Rules).⁷¹ Thus, although the new Hong Kong avoidance powers (like their English counterparts) are now extraterritorial, there is no mechanism in Hong Kong for serving avoidance actions on any person outside Hong Kong. An equivalent to U.K. Rule 12.12(3) needs to be introduced as soon as possible into both the Bankruptcy Rules and the Companies Winding-up Rules.

IV. Conclusion

The territorial application of avoidance powers in insolvencies was better suited to an older era. But now that it is possible to transfer enormous sums of money around the world with just a few clicks of a mouse,⁷² it is important that trustees and liquidators have extra-territorial avoidance powers that enable them to respond effectively. By modeling its avoidance powers on those of England, Hong Kong is moving, albeit perhaps accidentally, in the right direction. A deliberate decision needs now to be taken to amend the Bankruptcy Rules and the Companies Winding-up Rules, to permit service to be effected on persons outside the jurisdiction.

70. United Kingdom Insolvency Rules of 1986, S.I. 1986, No. 1925.

71. Hong Kong Companies (Winding-up Rules), cap. 32, sub. leg. H, L.H.K. (1999). Pursuant to Order 1, Rule 2(2) of the Rules of the High Court, Ch. 4. L.H.K. (1999), the Rules of the High Court are not applicable in bankruptcy proceedings or in proceedings relating to the winding up of companies. Section 113 of the Bankruptcy Ordinance provides that the Chief Justice, with the approval of the Legislative Council, may make general rules to carry into effect the objects of the Bankruptcy Ordinance. Section 296 of the Companies Ordinance similarly provides for the making of rules for the winding up of companies.

72. See *The Cornelis Verolme* [1997] 2 N.Z.L.R. 110, 126. (N.Z.)

