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Insolvency Law: A Comparative Analysis of the Preference Tests in the Hong Kong Special Administrative Region (HKSAR) and Australia

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Insolvency Law: A Comparative Analysis of the Preference Tests in the Hong Kong Special Administrative Region (HKSAR) and Australia[1]

By Shirley Quo[2]

Abstract

This article examines the unfair preference tests under corporate insolvency legislation in the HKSAR and Australia and undertakes a comparison of the law as it exists in relation to the tests in these jurisdictions. It suggests that the objective effects-based test used in the Australian provisions may be more effective in terms of challenging unfair preferences than the subjective "desire" test based on the actual or presumed intention of the debtor company used in HKSAR.

Introduction

The purpose of this article is to examine the unfair preference tests in the Australian *Corporations Act* 2001 (Cth) and the HKSAR *Companies Ordinance* (Cap 32) and in the course of doing so to undertake a comparison of the law existing in each of the two jurisdictions. Both the HKSAR and the Australian legal system were founded upon the English system. While there are similarities between the provisions in each country, there are also significant differences.

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[1] I would like to thank the Law School at City University of Hong Kong, and in particular the Head of the Law School, Professor DK Srivastava, for the kind hospitality which was extended to me while I was a visiting lecturer in 2006. I also acknowledge the financial assistance of the Law School at City University of Hong Kong which permitted me to conduct the initial research for this article.

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The fundamental purpose of an insolvency law (derived from bankruptcy law) in both jurisdictions is to provide a fair and orderly process for dealing with the financial affairs of insolvent companies. The principle of equal sharing between unsecured creditors should be retained and as far as is possible and practical, insolvency law should harmonise with the general law.

The preference provisions have existed, inter alia, to ensure that companies do not dispose of their assets to parties who are not entitled to them, and to stop companies preferring one or more unsecured creditors, to the disadvantage of the general body of unsecured creditors.

The consequences of the policy is that transactions which affect the disposition of assets or other property before the commencement of winding up may be reviewed and avoided, and if they are avoided the assets disposed of by the debtor company may be recovered and made available to meet the claims of the creditors of the company. The common policy is that creditors in general are protected against a diminution of the company's assets which confers an unfair or improper advantage on the other party to the transaction. This is designed to prohibit the unjust enrichment of the party who received property from the company, to the detriment of all other creditors. If such transactions could not be avoided it would be open to a debtor company, before liquidation, to dissipate its assets in favour of whomsoever it pleased and this would not be in accord with the pari passu principle which dictates that there should be a fair and equitable distribution of the debtor's assets among the creditors. The pari passu principle has been widely regarded as constituting the essential rationale for the existence of the avoidance provisions.

Firstly, the article examines the legislative framework which is provided in each country followed by relevant case law. Secondly, the article compares the substantive preference provisions applying in the HKSAR and Australia by reference to its historical background in the UK. Finally, the article seeks to draw some conclusions from a comparison of the two tests. The intention of the article is to make a comparative analysis between the respective jurisdictions and to come to some conclusions as to the effectiveness of the unfair preferences tests in each country.

Australian Law

Legislative background

> The unfair preference provisions of the corporate insolvency legislation, the *Corporations Act* 2001 (Cth), are expressed differently from those previously incorporated from the personal insolvency legislation, the *Bankruptcy Act* 1966 (Cth). However it does not appear that they were intended to make any substantive change for identifying what is an unfair preference, except in a few minor respects and except insofar as the relevant sections now appear in the *Corporations Act* itself.
>
> The applicable legal principles are only to be appreciated with regard to the history of the unfair preferences provisions. The form of the old bankruptcy and insolvency law represented a substantial adoption of the New South Wales (NSW) approach to what had been known in England and the Australian colonies during the 19th century as the doctrine of fraudulent preferences.[3]

[3] This doctrine was developed by Lord Mansfield who was appointed Chief Justice of the King's Bench in 1756. The historical development of the law of preferences in Australia was

The NSW approach was to treat transactions with creditors by a debtor contemplating bankruptcy as preferential if they had the effect of preferring the creditors to the general body of unsecured creditors, whether the debtor had any intent to prefer those creditors, or not. The bankruptcy statutes of all the other Australian jurisdictions kept, until they were superseded by the Commonwealth legislation, the idea, which originated in England in the 18th century and was still retained there, that for a transaction with a creditor by a debtor contemplating bankruptcy to be found void as a preference, the debtor's trustee in bankruptcy had to show that the debtor had subjectively intended to prefer the creditor by entering into the transaction.

The important feature of the NSW Act[4] was that it did away with the debtor's subjective intent to prefer as a necessary ingredient of a fraudulent preference. The legislation[5] declared void any transfer of any property made by any person being insolvent or approaching insolvency and having the *effect* of preferring any existing creditor to another. This concept was known as the de facto preference. The words of the statute clearly excluded the need for any preferential intention.

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discussed by the Full Court of the Federal Court of Australia in *Ferrier and Another v Civil Aviation Authority* (1994) 127 ALR 472 at 484 - 488.

[4] Section 8 of the Insolvency Act 1841 (NSW) introduced the phrase "having the effect of preferring any then existing creditor to another". It stated:

> "And be it enacted, that all alienations transfers gifts surrenders deliveries mortgages or pledges of any estate goods or effects real or personal … entered up thereon made by any person being insolvent or in contemplation of surrendering his estate as insolvent or knowing that legal proceedings for obtaining an order for the sequestration of his estate as insolvent, have been commenced or within sixty days preceding the making of any order for sequestration of his estate as insolvent, and having the effect of preferring any then existing creditor to another shall be and are hereby declared to be absolutely void."

[5] Section 8 of the Insolvency Act 1841 (NSW).

In *S Richards and Company Ltd v Lloyd* [6], the High Court of Australia[7] confirmed that the effect of a payment on the other creditors of the debtor is determined objectively.[8] If the payment has the effect of giving a creditor a preference over the other creditors, it does not matter that neither the creditor nor the debtor intended to give the creditor preferential treatment. Subsequent decisions by the High Court[9] have confirmed that there have been no substantive changes made to the current preference provisions in respect of the preference test. This position is referred to as 'the objective theory of preferences'.

Corporations Act 2001 (Cth) ("the Corporations Act")

Diagram of Avoidance Provisions[10]

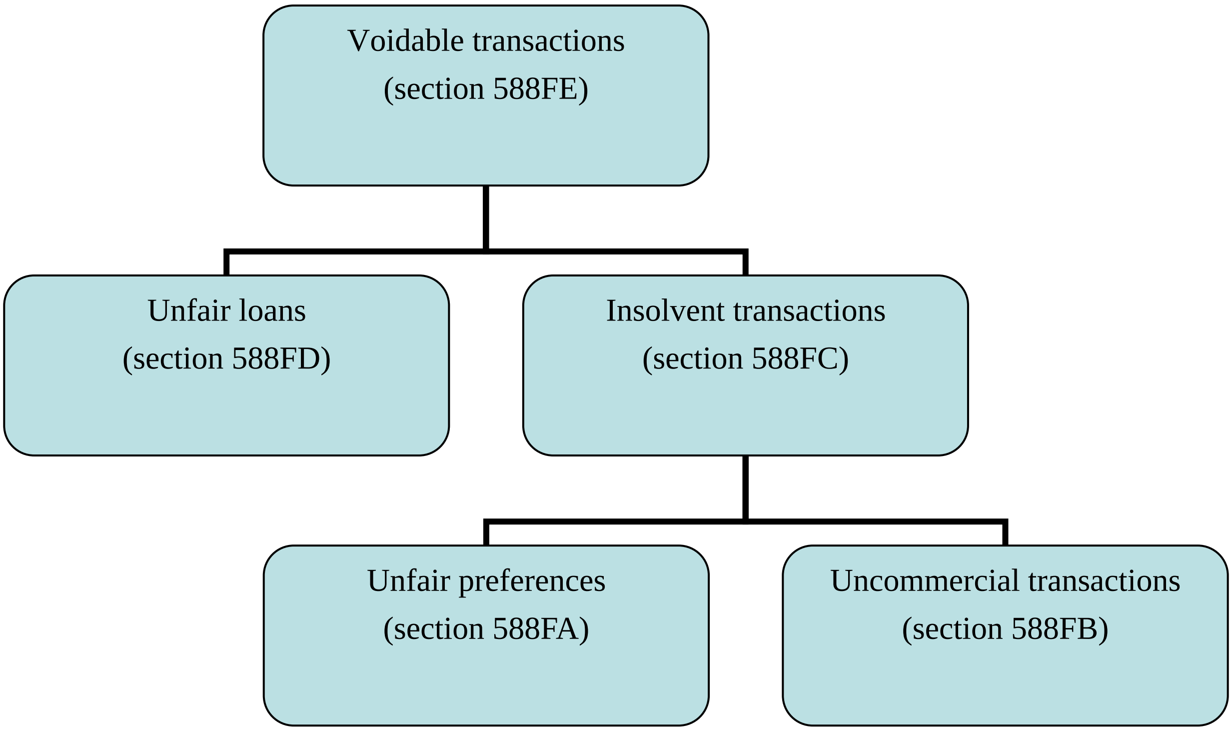
[6] (1933) 49 CLR 49. The decision was based on s 95 of the Bankruptcy Act 1924 (Cth), the predecessor to the current Act, which provided that a payment was a preference if it was made in favour of a creditor of the bankrupt and "having the effect" of giving that creditor a preference.

[7] The High Court of Australia exercises a defined original jurisdiction and an appellate jurisdiction as the final Court of Appeal within the Australian legal system including hearing appeals from state Supreme Courts and the Federal Court of Australia. It is the highest appellate court in the Australian jurisdiction which is equivalent to the Court of Final Appeal in the HKSAR.

[8] *S Richards and Company Ltd v Lloyd* (1933) 49 CLR 49 at 62; *Richardson v Commercial Banking Company of Sydney Ltd* (1952) 85 CLR 110 at 129.

[9] See *Airservices Australia v Ferrier* (1996) 137 ALR 609 at 623 and *Sheahan v Carrier Air Conditioning Pty Ltd* (1997) 147 ALR 1 at 38.

[10] Andrew Keay, *McPherson: the Law of Company Liquidation* (Sydney, LBC Information Services, 4th edn, 1999), p 430.



For transactions before section 588FA of the *Corporations Act* came into operation on 23 June 1993, the setting aside of unfair preferences was governed by section 122 of the *Bankruptcy Act*[11] as partly applied by section 565 to a company in liquidation.[12] Unlike section 588FA(1) of the *Corporations Act*, section 122 refers to payments by a bankrupt that have the effect of giving a creditor "a preference, priority or advantage" over other creditors. When section 122 of the *Bankruptcy Act* applied to companies, certain payments or transfers by an insolvent company to one of its creditors

[11] Section 122 of the Bankruptcy Act 1966 (Cth) corresponds with the previous s 95 of the Bankruptcy Act.
[12] Section 565(1) of the Corporations Law provided that a payment made by a company that, if it had been made by a natural person, would, in the event of bankruptcy, be void as against the trustee in bankruptcy, was, in the event of the company being wound up, void as against the liquidator. This was a reference to s 122 of the Bankruptcy Act 1966 (Cth).

would not be held to be voidable preferences if they did not disadvantage other creditors that the company had when the payment was made.

In substance, section 588FA(1) provides that a transaction is an unfair preference given by a company to a creditor of the company if the transaction *results* in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company.

Under earlier legislation, preferential transactions were called voidable preferences or undue preferences. For preferences effected after 23 June 1993, the *Corporations Act* is no longer dependent on the *Bankruptcy Act* and has its own provisions in sections 588FA to 588FI. They contain many of the elements in the earlier legislation and many judicial decisions on the earlier legislation will govern their interpretation.[13]

The relevant provisions of the *Corporations Act* affecting voidable preferences in insolvency are to be found in Division 2 of Part 5.7B. Section 588FE prescribes what transactions are voidable when a company is being wound up. In essence, the transaction is voidable if it is an 'insolvent transaction' of the

[13] It is clear that no change was intended to be made to the nature of a preference under the new legislation. This was set out in the explanatory memorandum published for the Corporate Law Reform Bill 1992, paragraphs 1033-1042, and from the reported cases which have dealt with s 588FA: see *Re Emanuel (No. 14) Pty Ltd; Macks v Blacklaw and Shadforth Pty Ltd* (1997) 147 A.L.R. 281; *Jonas v Automation House Pty Ltd* [1998] VSC 9.

company and it was entered into during the six months before the company was wound up in insolvency.[14] 'Transaction' is broadly defined as a transaction to which the company is a party and includes a payment made by the company; a conveyance, transfer or other disposition by the company of property of the company; a charge created by the company on the company's property.

As indicated in the diagram above,[15] a transaction will be a voidable under Part 5.7B if it is an unfair preference that satisfies another condition of being an insolvent transaction. Relevantly, an insolvent transaction is one in which an unfair preference has been given by the company, when it is insolvent, or becomes insolvent because of the transaction.[16] Accordingly, in order to determine whether the relevant payments constituted insolvent transactions the liquidator must establish that the company was insolvent when the payments were made.[17]

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[14] This is referred to as the relation-back day in s 9 of the Corporations Act 2001 (Cth). The relation-back day means, inter alia, the day on which the application for the winding-up order was filed or the day on which the winding up is taken to have begun. Liquidators are entitled to make certain rebuttable presumptions in proving the insolvency of a company at a particular time. The presumption that a company is insolvent in certain circumstances is contained in s 588E(3).

[15] There is considerable overlap between the various antecedent transaction provisions in the Corporations Act 2001 (Cth). For example, in *Ziade Investments Pty Ltd v Welcome Homes Real Estate Pty Ltd* [2006] NSWSC 457 the court appears to suggest that a transaction (in that case, a mortgage to secure a previously unsecured debt) may at the same time amount to an unfair preference under s 588FA, an uncommercial transaction under s 588FB, as well as an unreasonable director related transaction under s 588FDA.

[16] Section 588FC of the Corporations Act 2001 (Cth).

[17] A company is insolvent if it is unable to pay its debts, as and when they become due and payable: s 95A of the Corporations Act 2001 (Cth). This is the cash flow test.

Subject to section 588FG[18], where an unfair preference has been given, the transaction is voidable and the court is empowered to make orders directing a person to pay to the company an amount equal to some or all of the amount the company paid under the transaction, provided that the transaction was made within the prescribed period and was an insolvent transaction.

In summary, the liquidator must show that each payment occurred in a transaction that was an unfair preference given by the company to a creditor, that the transaction was an insolvent transaction and that it was a voidable transaction within the preferential period. If all these elements are established, the court has power to make an order in effect directing repayment.[19]

Although the normal period is six months, if a related entity[20] of the company was a party to the insolvent transaction, the transaction is voidable if it occurred within four years of the winding up.[21] If the company became a party to the insolvent transaction for the purpose of defeating, delaying or interfering with the rights of any or all of its creditors, the transaction is voidable if it occurred within 10 years of the winding up.[22]

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[18] Section 588FG of the Corporations Act 2001 (Cth) provides a good faith defence where the other party acted in good faith, did not suspect that the company was insolvent and provided valuable consideration or changed their position in reliance on the transaction.

[19] See s 588FF(1)(a) of the Corporations Act 2001 (Cth).

[20] "Related entity" is defined widely in s 9 of the Corporations Act 2001 (Cth). It includes directors, relatives of directors, bodies corporate having a director in common with the company, related companies and certain trusts.

[21] Section 588FE(4) of the Corporations Act 2001 (Cth).

[22] Section 588FE(5) of the Corporations Act 2001 (Cth).

Australian Case Law

Since the decision in *S Richards and Company Ltd v Lloyd*[23] it has not been necessary for liquidators in Australia to prove any mental element on the part of either the debtor or the creditor in order to establish the existence of a preference. In that case, the High Court rejected a submission that the relevant provision[24] which dealt with preferences required a consideration of the state of mind of the debtor. Starke J was of the opinion that the *Bankruptcy Act* was not concerned with intention or state of mind, rather, it looked to the effect of the transaction.[25]

The Australian courts have consistently applied an objective test rather than a subjective test. The Full Court of the Supreme Court of South Australia asserted in *Matthews v Geraghty*[26] that the term 'preference' does not of itself possess any subjective or purposive element. In *Ferrier v Civil Aviation Authority*,[27] the Full Court of the Federal Court stated that courts in Australia are only concerned with the effect of the transaction and not the motive of the debtor.[28] This was subsequently affirmed by the High Court.[29] In another

[23] (1933) 49 CLR 49.
[24] Section 95 of the Bankruptcy Act 1924 (Cth).
[25] *S Richards and Company Ltd v Lloyd* (1933) 49 CLR 49 at 62.
[26] (1986) 11 ACLR 229 at 232.
[27] (1994) 127 ALR 472.
[28] (1994) 127 ALR 472 at 486.
[29] See *Airservices Australia v Ferrier* (1996) 137 ALR 609 at 623. Toohey J from *Airservices v Ferrier* 137 ALR 609 at 635 said that the words "having the effect of" fasten on to the transaction itself. They do not look to the intent or state of mind of the debtor when making payment.

High Court decision, *Sheahan v Carrier Air Conditioning Pty Ltd* [30], Kirby J in his dissenting judgment noted that no intention to effect a preference is necessary.[31] His Honour also indicated that the motivation of the payer in making the payments is irrelevant to the determination of their effect.[32]

However, although actual or subjective intention to give a preference is irrelevant, “that does not mean that the *purpose* of the debtor in making a payment has no evidentiary significance” (emphasis added).[33] For example, if the purpose of a payment is to secure an asset of equal or greater value, the payee receives no advantage over other creditors. The other creditors are no worse off and, where the value of the assets has increased, they are actually better off.

Consistently with this view, the majority in *Airservices Australia v Ferrier*[34] said that:

> “[T]he *purpose* for which the payment was made and received will usually determine whether a payment has the *effect* of giving the creditor a preference, priority or advantage over other creditors” (emphasis added).

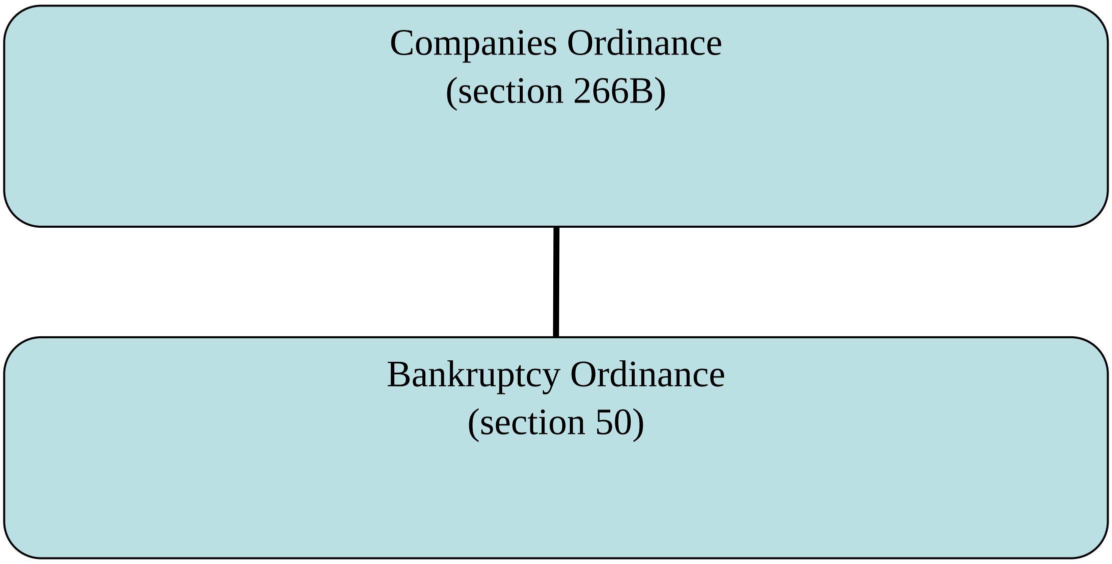
In other words, the High Court clearly recognised that the objective purpose, in a business sense, of the whole transaction must be considered by the court in order that it can “look to the ultimate effect of the transaction”[35]. However,

[30] (1997) 147 ALR 1; (1997) 189 CLR 407.
[31] (1997) 147 ALR 1 at 39.
[32] (1997) 147 ALR 1 at 41.
[33] *Airservices Australia v Ferrier* (1996) 137 ALR 609; Dawson, Gaudron and McHugh JJ at 623.
[34] Ibid.
[35] *Airservices Australia v Ferrier* (1996) 137 ALR 609; Dawson, Gaudron and McHugh JJ at

this statement was made in the context of an ongoing financial relationship between the parties where the continuing supply of goods or services by the creditor was linked to continuing payments by the company (the running account cases).[36]

Hong Kong Law

Companies Ordinance (Cap 32)



The law of fraudulent preferences was changed on 1 April 1998 in the HKSAR.[37] Before that date, by section 266 of the *Companies Ordinance*, Cap 32, transactions including payments could be invalidated if done within six months before the commencement of a company's winding up and if deemed a fraudulent preference.[38]

629.

[36] See *Richardson v Commercial Banking Company of Sydney Ltd* (1952) 85 CLR 110; *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266; *Re Weiss; Ex parte White v John Vicars & Co Ltd* [1970] ALR 654. Running accounts are now embodied in s588FA(3) of the Corporations Act 2001 (Cth).

[37] The changes were based on equivalent provisions in the UK Insolvency Act 1986 as recommended by the Law Reform Commission of Hong Kong in its report, 'The winding-up provisions of the *Companies Ordinance*'.

[38] Section 266 of the *Companies Ordinance*, Cap 32, provides that:

The relevant statutory provision is section 266B of the *Companies Ordinance*.[39] This provision provides that a reference in section 266 (fraudulent preference) shall be deemed to be a reference to an unfair preference as provided for in section 50 of the *Bankruptcy Ordinance,* Cap 6. It is then necessary to refer to sections 50, 51, 51A and 51B of the *Bankruptcy Ordinance*. These provisions are modelled on sections sections 239, 240 and 241 of the *Insolvency Act* 1986 in England ("the UK Act").

Broadly speaking, the following elements must be present in order to constitute an unfair preference:

(a) a preference within the meaning of section 50(3) of the *Bankruptcy Ordinance*[40] was given by the bankrupt at the relevant time;

(b) the bankrupt was influenced by the requisite desire as defined in section 50(4) of the *Bankruptcy Ordinance*[41] when he gave the preference;

"[a]ny ... payment .. made ... by ... a company within 6 months before the commencement of its winding-up which, had it been made ... by ... an individual within 6 months before the presentation of a bankruptcy petition on which he is adjudged bankrupt, would be deemed in his bankruptcy a fraudulent preference, shall in the event of the company being wound up deemed to be a fraudulent preference of its creditors and be invalid accordingly."

[39] By s266B, the new concept of 'unfair preference' in the *Bankruptcy Ordinance*, Cap 6, was made applicable to companies.

[40] Section 50(3) of the *Bankruptcy Ordinance*, Cap 6, relevantly paraphrased, provides that a debtor gives an unfair preference to a person if (a): that person is one of the debtor's creditors or a surety or guarantor for any of his debts or other liabilities; and (b): the debtor does anything which has the effect of putting that person into a position which, in the event of the debtor's bankruptcy, will be better than the position he would have been in if that thing had not been done.

[41] Section 50(4) of the *Bankruptcy Ordinance*, Cap 6, relevantly paraphrased, provides that the court shall not make an order in respect of an unfair preference given to any person unless the debtor was influenced in deciding to give it by a desire to produce the effect mentioned in subsection (3)(b).

(c) the bankrupt was insolvent at the time of the transaction or he became insolvent in consequence of that transaction, see section 51(3) of the *Bankruptcy Ordinance*.[42]

A company gives an unfair preference if the person given the preference is one of the company's creditors or a surety or a guarantor for any of the debts or liabilities of the company, and the company does something which has the effect of putting that person into a position which, in the event of the company being wound up, is better than the position he would have been in if that thing had not been done.

The effect is that where a company is wound-up and it has, at the relevant time[43], given an unfair preference to any person, the liquidator may apply to the court for an order that the position should be restored to what it would have been if the company had not given the unfair preference.[44]

The reference to "fraudulent", and therefore the implication that an improper motive must be shown, has been removed. Under the new provision, a liquidator does not need to show that the dominant intention[45] was to give one

[42] Section 51(3) of the *Bankruptcy Ordinance*, Cap 6, relevantly paraphrased, provides that a debtor is insolvent if (a) he is unable to pay his debts as they fall due; or
(b) the value of his assets is less than the amount of his liabilities, taking into account his contingent and prospective liabilities.

[43] The relevant time is two years before the date of the presentation of the petition to wind up a company in respect of a person who is an associate of the company, and six months before presentation in respect of anyone else: s 51 of the *Bankruptcy Ordinance*.

[44] Section 50(2) of the *Bankruptcy Ordinance*. Note that s 264 of the *Companies Ordinance* provides that the bankruptcy rules shall apply to the winding up of insolvent companies.

[45] This was based on the former law of fraudulent preferences under s 266(1) of the *Companies Ordinance* which incorporated by reference s 49 of the *Bankruptcy Ordinance*. The old s 49(1) of the *Bankruptcy Ordinance* provided that:

creditor a preference however the court will only make an order under the section if the company giving the unfair preference was influenced in deciding to give it by a “desire” to put the person into a better position than he would have been in.[46]

The trustee in bankruptcy bears the burden of establishing that the debtor giving the unfair preference was “influenced” by the requisite “desire”. If the person preferred is an associate of the company, otherwise than by reason of being an employee, the desire to put the person into a better position is presumed, unless the contrary is shown.[47]

An “associate” has a similar meaning to the meaning of “associate” in the UK Act being the debtor’s spouse or a close relative, or the spouse of a relative of the debtor or his spouse, partner, co-worker, trustee, director, or “controlling” person.[48]

> "... every payment made ... by any person unable to pay his debts as they become due from his own money in favour of any creditor … with a view to giving such creditor, or any surety or guarantor for the debt due to such creditor, a preference over the other creditors, shall, if the person making, ... the same is adjudged bankrupt on a bankruptcy petition presented within 6 months, ... after the date of making, ... the same, be deemed fraudulent and void as against the trustee in the bankruptcy."

This provision had been construed by the courts as requiring the person seeking to avoid the payment to establish that it had been made “with the dominant intention to prefer” the creditor.

[46] Section 50(4) of the *Bankruptcy Ordinance* indicates that the court shall not make an order in respect of an unfair preference given to any person unless the debtor who gave the unfair preference “was influenced in deciding to give it by a desire to produce in relation to that person” the preferential position complained of.

[47] Section 50(5) of the *Bankruptcy Ordinance* – statutory presumption which can be rebutted by contrary evidence.

[48] Section 51B of the *Bankruptcy Ordinance*.

Hong Kong Case Law

The *Trustees of the Property of Hau Po Man Stanley (in bankruptcy) v Hau Po Fun Ivy*[49] ("*Hau Po Man*") was a HK Court of Appeal[50] decision which dealt with the bankruptcy provisions in respect of unfair preferences. The statutory presumption applied as the payment was made to an associate of the debtor (his sister and brother-in-law). There were two payments in issue.

The provisions directly relevant to this appeal are sections 50(4)[51] and 50(5) of the *Bankruptcy Ordinance*. Section 50(5) of the *Bankruptcy Ordinance*[52] purports to ease the trustee's task in instances in which the unfair preference was given by the debtor to an "associate". This category of persons is defined within section 51B of the *Bankruptcy Ordinance*.[53]

In this instance, therefore, the burden was reversed. An "associate" is faced with rebutting the statutory presumption, the conceptual underpinning for which stems from recognition of the bond existing between family members.

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[49] [2005] 2 HKC 227.

[50] The Court of Appeal hears appeals from civil cases decided by the Court of First Instance. Appeals are heard and decided by three Justices of Appeal.

[51] See note 45 above.

[52] Section 50(5) of the *Bankruptcy Ordinance* provides:

> "A debtor who has given an unfair preference to a person who, at the time the unfair preference was given, was an associate of his … is presumed, unless the contrary is shown, to have been influenced in deciding to give it by such a desire as is mentioned in subsection (4)".

[53] Section 51B(2) is the relevant subsection, which reads:

> "A person is an associate of a debtor if that person is the debtor's spouse, or is a relative, or the spouse of a relative of the debtor or his spouse".

This was the position in the case the subject of this appeal, wherein it was the debtor's sister and brother-in-law who had been beneficiaries of the three preferences in question.

In her leading judgment, Le Pichon JA accepted the test set out by Millett J in *Re M C Bacon Ltd* ("*Bacon*")[54] that "intention is objective, desire is subjective. A man can choose the lesser of two evils without desiring either."

Le Pichon JA said that pressure (either commercial or moral) could remove the presumption. What is crucial is that the pressure has the effect of causing the person upon whom the pressure is applied to perform the act in question. The *Bacon* case did not decide that a distinction should be drawn between moral pressure and commercial pressure. Her Honour said that moral pressure can be every bit as real as commercial pressure. In deciding to make the transfer of the share to his sister and the car to his brother-in-law, the bankrupt was motivated by a desire to put an end to the disruption to his professional practice caused by his brother-in-law's visits and to preserve his family ties with his relatives. In other words, the decision to make those transfers was actuated by the pressure that had been brought to bear upon the bankrupt by his sister and her husband. That finding was sufficient to displace the statutory presumption.

In relation to the payment to the sister out of the insurance proceeds received by the bankrupt, the majority noted that the evidence as to the circumstances surrounding the transfer was unclear and less than satisfactory. In those circumstances, the statutory presumption prevailed.

[54] [1990] BCC 78 at 87.

The minority held that the statutory presumption had not been rebutted in relation to both payments.

The *Bacon* case, which is notable for the observations of Millett J on the provisions as to corporate preference equivalent to sections 50(3) and (4) of the *Bankruptcy Ordinance*, on its facts did not involve any "associate", and dealt with that which ostensibly was an arm's-length commercial transaction. Le Pichon JA incorrectly observed that, in the area of the statutory presumption within section 50(5) of the *Bankruptcy Ordinance*, which is central to this case, there appears to be no relevant case law.[55]

The decision of the HK Court of Appeal in *Hau Po Man* is important as it is the first case in which the "desire" test in section 50(4) of the *Bankruptcy Ordinance* has been judicially explained and applied.

Re Phantom Records Ltd & Another[56] ("*Phantom*") was an application by the Official Receiver seeking disqualification orders against James Conrad Louey ("the first respondent") and Cheng Yin Bong Jason ("the second respondent"), on the basis of their conduct as directors of Phantom Records Limited ("Records") and Phantom Music Limited ("Music").

The Official Receiver alleged that the respondents caused Records to enter into an unfair preference within section 266B of the *Companies Ordinance*.

There was no dispute that at the time the transaction was made, the

[55] See for example, *Re DKG Contractors Ltd* [1990] BCC 903; *Wills and Another v Corfe Joinery Ltd (in liq)* [1997] BCC 511; *Re Agriplant Services Ltd* [1997] BCC 842 where the statutory presumption applied to the equivalent UK provision.
[56] [2006] HKEC 2233 (7 December 2006, Court of First Instance).

respondents were creditors of Records (as required by section 50(3)(a) of the *Bankruptcy Ordinance*) and associates of Records (pursuant to section 51B(4) of the *Bankruptcy Ordinance*). The Official Receiver relied on the presumption in section 50(5) so as to place the burden on the respondents to show that in entering into the transaction, they were not influenced by a desire of putting themselves in a position which, in the event of Record's liquidation, would be better than the position they would have been in if the transaction had not been done.

Kwan J said that two elements are required to be established: a desire to produce the effect of improving the creditor's position in an insolvent liquidation, and such desire had influenced the decision to enter into the transaction.[57] His Honour referred to the test in *Bacon* which had been followed by the HK Court of Appeal in *Hau Po Man*.[58] A desire of improving the creditor's position in an insolvent liquidation is a subjective state of mind. As for influence, this requirement is satisfied if it was one of the factors which operated on the minds of those made the decision.

Here, as the statutory presumption in section 50(5) of the *Bankruptcy Ordinance* applies, Records was presumed to have been influenced in deciding to make the payment by the relevant desire, unless the contrary was shown. Examples where the presumption was not rebutted were where the director was unable to show proper commercial considerations for the transaction.

[57] *Re Phantom Records Ltd and Another* [2006] HKEC 2233 at para 86.
[58] The Court of First Instance would be bound by the doctrine of precedent as a lower court in the same hierarchy.

Conversely, where proper commercial considerations were shown, the presumption was rebutted.[59]

There was no compelling commercial reason for the payment apart from improving the position of the respondents. Even if the presumption were not to apply, Kwan J said that he would have been prepared to infer from the evidence there was in existence a state of mind on the respondents' part to desire the consequence of putting themselves in a better position in an insolvent liquidation.

Apart from this case, at the time of writing, there are no HK cases which have judicially considered the 'desire' test and unfair preferences in relation to companies and payments to non-associates.[60] For guidance, it is necessary to refer to the ratio decidendi in *Bacon*, which was judicially endorsed by the HK Court of Appeal in *Hau Po Man* and the Court of First Instance in *Phantom*.

UK Case Law

Re MC Bacon Ltd [61] ("*Bacon*") is the first decision dealing with the current preference test in England, on which the preference test in the HKSAR is based. The liquidator applied to the court to have a debenture set aside under

[59] *Re Phantom Records Ltd and Another* [2006] HKEC 2233 at para 89.
[60] Apart from the two cases discussed, the only other case dealing with the "desire" test and unfair preferences in HK was *Re Asean Interests Ltd* [2005] HKEC 1539 (29 September 2005), Court of First Instance. This was an application by the Official Receiver seeking disqualification orders against the directors of the company on the basis, *inter alia*, that they had received unfair preferences under s 266B of the *Companies Ordinance*. As in *Phantom*, the statutory presumption applied and there were admissions made by the directors in relation to the payments.
[61] [1990] BCC 78.

section 239 of the UK Act as a preference.[62] The liquidator argued, *inter alia*, that the directors were influenced, when they agreed to the bank's request for a debenture, by a desire to improve the bank's position in the event of the company's insolvent liquidation within sections 239(4)(b) and (5) of the UK Act.

The court noted that the bank's continuing support was conditional upon the provision of a debenture over the company's fixed and floating assets including a specific charge over the freehold property owned by the company. The bank's support was dependent upon its debenture and fixed charge over the property having first priority. The directors knew that the company was insolvent and that if the bank withdrew its support at any time the company would be forced into immediate liquidation.

Millet J highlighted some differences between the old law[63] and the new law. In contrasting the distinction between the concept of *desire* under the new law and that of *intention* under the old law, the learned judge made the following comments[64]:

[62] Section 239(4) of the Insolvency Act 1986 (UK) relevantly provides that a company gives a preference to a person if that person is one of the company's creditors and the company does anything which has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done. However, the court shall not make an order unless the company which gave the preference was influenced in deciding to give it by a desire to produce in relation to that person the effect mentioned: s 239(5).

[63] Section 44(1) of the Bankruptcy Act 1914 (UK).

[64] *Re MC Bacon Ltd* [1990] BCC 78 at 87.

- Intention is objective, desire is subjective. A man can choose the lesser of two evils without desiring either;
- The relevant desire is a desire to produce the effect of putting a creditor into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would otherwise have been in; and
- A man is not to be taken as desiring all the necessary consequences of his actions.

In the context of corporate insolvency, Millett J said it is still possible to uphold a transaction made by a company in financial difficulties provided that the company is actuated only by proper commercial considerations.[65]

Millett J dismissed the liquidator's application to have the debenture set aside as a preference under section 239 of the UK Act and said that the transaction would not be set aside under that section unless the company positively wished to improve the creditor's position in the event of insolvent liquidation, that the requisite desire must have influenced the decision to enter into the transaction, and that that requirement was satisfied if it was one of the factors that operated on the minds of those who made the decision at the time when the decision was made.[66]

In deciding to grant the debenture to the bank the directors were not motivated by any desire except the desire to avoid the calling in of the overdraft and to continue trading. They were not actuated by any desire to improve the bank's position as a creditor in the event of the company's liquidation.

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[65] Ibid.
[66] *Re MC Bacon Ltd* [1990] BCC 78 at 88.

According to Millet J, the current provision is a completely different test which involves a radical departure from the old law. Firstly, it is no longer necessary to establish a dominant intention to prefer. It is sufficient that the decision was influenced by the requisite desire. Secondly, it is no longer sufficient to establish an intention to prefer. There must be a desire to produce the effect mentioned in the subsection. Millett J said that this second change was made necessary by the first, for without it, it would be virtually impossible to uphold the validity of a security taken in exchange for the injection of fresh funds into a company in financial difficulties. A man is taken to intend the necessary consequences of his actions, so that an intention to grant a security to a creditor necessarily involves an intention to prefer that creditor in the event of insolvency. The need to establish that such intention was dominant was essential under the old law to prevent perfectly proper transactions from being struck down. With the abolition of that requirement intention could not remain the relevant test. Desire has therefore been substituted.[67]

Millet J said that there is no need for there to be direct evidence of the requisite desire.[68] Its existence may be inferred from the circumstances of the case just as the dominant intention could be inferred under the old law.[69] But the mere presence of the requisite desire by itself will not be sufficient. It must have influenced the decision to enter into the transaction.[70] The

[67] *Re MC Bacon Ltd* [1990] BCC 78 at 87.
[68] *Re MC Bacon Ltd* [1990] BCC 78 at 88.
[69] Ibid.
[70] Ibid.

requirement in section 239(5) of the UK Act is satisfied if it was one of the factors which operated on the minds of those who made the decision - it need not have been the only factor or even the decisive one.[71]

The court held that there was no evidence that the company wanted to improve the bank's position in the event of an insolvent liquidation and there was no reason why they should. In deciding to grant the debenture to the bank the company was only motivated by the desire to avoid the calling in of the overdraft and to continue trading. The company's relationship with the bank was an arm's length one and the company through its directors was not influenced by personal financial considerations.

This case illustrates how difficult it is to prove the requisite desire exists – at least in relation to arms-length transactions where there is no presumption of desire as there is in relation to associates.

In subsequent cases, the statutory presumption applied as the payment was made to a connected person[72]: *Re DKG Contractors Ltd* [73]; *Re Fairway Magazines Ltd*[74]*; Wills & Anor v Corfe Joinery Ltd (in liq)*[75]*; Re Agriplant Services Ltd* [76].

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[71] Ibid.
[72] The statutory presumption in s 239(6) of the Insolvency Act is equivalent to s 51B of the *Bankruptcy Ordinance* which reverses the onus of proof where the payment is made by the company to a related party.
[73] [1990] BCC 903. The husband and wife were the directors and shareholders of the company. The husband was the company's main creditor.
[74] [1992] BCC 924 Ch D. The facts in this case are similar to *Bacon* in that the company gave the director a debenture as security for payments which the director was to make to the company under a loan agreement. The payments were required in order that trade could be continued while a rescue was attempted; without the payments, the company would have gone into liquidation. Following the test in *Bacon*, the court held that there was no desire to

Analysis

In order to make a comparative analysis of the subjective "desire" test used in the HKSAR and the objective "effects" test used in Australia, it will be necessary to analyse Millet J's judgment in *Bacon*, which was endorsed by the HK courts.

Millett J's decision has been criticised for the view that cases decided under the old fraudulent preference provisions would not be of assistance because of the change of the wording in the legislation.[77] The learned judge referred to what he classed as two radical departures from the old law: one being the use of the word "desire" rather than "intention" and the other being the replacement of "dominant" intention with "influenced" by desire.[78] According to Millet J, intention is objective and desire subjective. This suggests that the old test was an objective one. However, *Sharp v Jackson*,[79] is clear authority that the courts always applied a subjective test prior to the current UK Act.[80] The old law required proof of the debtor's dominant intention to

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prefer; the company was attempting to keep trading in the hope of a rescue. In other words, the company was solely influenced by commercial considerations in its decision. This was the only decision in which the statutory presumption was rebutted.

[75] [1997] BCC 511. The payments were made for repayment of the directors' loan accounts.

[76] [1997] BCC 842. The company made a payment to a creditor to settle a debt which had been personally guaranteed by one of the directors. The court held in favour of the liquidator, ordering repayment of the money by the creditor to the company and payment in similar terms by the director to the creditor. The payment to the creditor had the effect of improving the position of both the creditor and the director as a contingent creditor under his guarantee to the creditor in the event of an insolvent liquidation of the company.

[77] See Ian F. Fletcher, "Voidable preference judicially explained", (1991) January, *Journal of Business Law* 71, 73; Taylor, Moira Taylor, "*Bacon* – well done?", (1990) May, *Butterworths Journal of International Banking and Financial Law* 212, 214.

[78] *Re MC Bacon Ltd* [1990] BCC 78, 87. Millet J said that this was a completely different test.

[79] [1899] AC 419.

[80] Moira Taylor, "*Bacon* – well done?", (1990) May, *Butterworths Journal of International Banking and Financial Law* 212, 214.

prefer a particular creditor in the sense of providing the court with “objective” proof as to the debtor’s subjective state of mind at the relevant time.[81]

Sharp v Jackson concerned a debtor who had committed breaches of trust and was insolvent. Just before he was declared bankrupt, he transferred share certificates belonging to his firm as security for monies outstanding to the trust. The transfers were made by the debtor without any pressure from the beneficiaries of the trust. The House of Lords held that there had been no fraudulent preference as the debtor’s motive was to shield himself from the consequences of his breaches of trust rather than to give a preference.

The House of Lords in *Sharp v Jackson* indicated that whether it is called “intention” or “view” or “object” does not really matter – what matters is whether in fact the debtor had the intention to prefer certain creditors.[82] In other words the English case law before 1986 also treated intention as being a subjective test. Accordingly, it is respectfully submitted that Millet J’s distinction between intention (objective) and desire (subjective) is open to question.

According to Professor Fletcher, the word “desire” carries a far more positive and forceful connotation than that which is conveyed by the word “intention” although both tests are subjective.[83] In the words of Millet J, the liquidator must establish that the debtor company “positively wished” to improve the creditor’s position in the event of its own insolvent liquidation. Section 239(5) of the UK Act and its

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[81] Ian F. Fletcher, “Voidable preference judicially explained”, (1991) January, *Journal of Business Law* 71, 73.
[82] See note 79 above, 214.
[83] See note 80 above, 73.

equivalent HK provision in section 50(4) of the *Bankruptcy Ordinance* do not require that the requisite desire to prefer the creditor was a dominant factor or the factor which 'tipped the scales'.[84] It is only necessary to establish that the requisite desire was one of a number of factors which influenced the decision – arguably a less demanding requirement than the old test. This may be difficult to establish in the absence of direct evidence of the requisite desire, although the court may infer the existence of the requisite desire from the circumstances of the case based on the debtor's conduct.

However, Millet J's decision in *Bacon* suggests that "influenced" by a desire to prefer may be just as difficult to prove as a "dominant" intention to prefer except where the statutory presumption applies.

In *Sharp v Jackson*, the House of Lords said that a transaction was not a fraudulent preference if it was entered into under genuine pressure. The argument was that "preferring" presumes free choice. If the pressure was such that the debtor felt compelled to enter into the transaction there was no exercise of free choice and hence no preference.

Section 239 of the UK Act and the equivalent provision in section 50(4) of the *Bankruptcy Ordinance* refer to a decision influenced by a desire to put the creditor into a better position. This is also the language of free choice. The same principles would therefore apply, in which case a transaction will not be set aside as a preference if it can be shown that it was entered into under pressure.

[84] Ibid.

In *Bacon*, it was alleged that a debenture and fixed charge given to the company's bank was a preference. There was evidence that the bank had threatened to withdraw the company's overdraft facilities unless it was given a first priority charge over the company's property. It does not appear to have been argued that this meant the decision to grant a charge was not a free decision of the company.[85] Instead, it was taken as evidence that underlying the decision was a desire to secure the company's future trading position rather than a desire to prefer the bank.[86] The existence of pressure could thus be used to argue that the debtor company acted under compulsion and therefore made no decision within the meaning of the preference provision; and that any decision was not influenced by a desire to prefer the creditor but by a desire to be relieved of the pressure. The existence of pressure has always been one of the most frequent grounds for resisting a preference claim and the current provision appears to have done little to change the position. It is open to liquidators to show that the debtor company would not have succumbed to the pressure were it not for a desire to prefer, but this was so under the previous law.[87]

The Earl of Halsbury in *Sharp v Jackson*[88] stated that he did not think a person intended the natural consequences of his actions for the purposes of a preference. This is similar to Millet J's statement that a man is not to be taken as desiring all the necessary consequences of his actions. Nevertheless, a distinction was drawn between intention and the motive behind that intention.

[85] Keith Otter, "Influential desire – dominant intention", (1990) 3(6) *Insolvency International* 42, 43.
[86] Ibid.
[87] Ibid.
[88] [1899] AC 419.

The conclusion in *Bacon* and *Hau Po Man* would probably have been the same under the previous law (despite Millett saying that the old case law was of no relevance). Millet J said that the company did not desire to prefer the bank; it desired to secure its own trading position. However, this appears to be the same as saying that the company's dominant intention was to secure its trading position. In other words, a dominant intention to prefer a creditor would also necessarily involve a desire to prefer that creditor.[89] His Honour said that it might be possible to infer a desire to prefer from the circumstances of a case but this was also applicable under the old test.

Unless it is admitted, liquidators in the HKSAR bear a heavy onus of proving the desire to prefer influenced the decision. In the absence of direct evidence, the only way the liquidator can do so is by showing that it is unlikely the directors reached the decision they did without taking the desire to prefer into account. The case law suggests that this will be difficult to prove unless the payee is a related party, in which case the statutory presumption applies. Whether or not desire to prefer "tipped the scales" may not be the legal test but it could be the practical one.[90]

Professor Goode asserts that the word "desire" is intended to represent no more than what may be called voluntary intent, that is, an intention which represents the free will of the debtor rather than an intentional act done under pressure from a creditor.[91] This therefore benefits creditors who put pressure on the debtor to pay up. This reasoning appears to be linked to the former doctrine of fraudulent preferences which stemmed from the need for the discharge of the debt by the debtor to have been voluntary.

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[89] Ibid.
[90] See note 84 above, 44.
[91] R.M. Goode, *The Principles of Corporate Insolvency Law* (London, Sweet & Maxwell,1990), p 172.

It is submitted that such an approach encourages substantial creditors, for example institutional lenders, to actively pressure debtors into giving preferences, and it produces problems for weaker creditors who are unable to use any kind of leverage against debtors (see *Bacon* for example).

According to Professor Fletcher,[92] the decision in *Bacon* would have had a profound bearing upon the future conduct of relations between banks and their financially stressed customers. Arguably, if Millet J had ruled in favour of the liquidator's application it would have ceased to be safe for any bank to rely upon this form of protective security, which is commonly used when a company is being "nursed" through a period of "intensive care" while it is at or near to insolvency.[93] As a consequence, many perfectly viable companies would have found it virtually impossible to obtain the necessary line of credit to enable them to overcome a temporary, and surmountable, crisis in their financial fortunes.[94] Similarly in Australia, there has been recognised the necessity of ensuring that a company facing winding up must have some ability to live out and survive its feared fate. It is in the interests of the body of unsecured creditors that there should remain a business which can be sold as a running concern, so long as its liabilities are not increased in the meantime. It has been accepted in Australia that, as long as the company does not pay out existing creditors without obtaining an effective corresponding advantage, then it should be allowed to acquire goods and services by prepayment or on cash on delivery terms. The rationale behind this is that the company gains goods and services to an equivalent value to that which it pays out to obtain them, so that the existing

[92] See note 80, 73.
[93] Ibid.
[94] Ibid.

creditors are not prejudiced by the payment. If a payment to a creditor is made in good faith and for valuable consideration, and the creditor did not suspect that the company was insolvent, the creditor is protected by section 588FG(2) of the *Corporations Act*. If there is a running account between the parties in the nature of a bank overdraft, such as in *Bacon*, Australia recognizes the running account principle by looking at the net effect rather than a particular transaction in isolation.[95] The running account principle has not been judicially recognised in England or the HKSAR.

Professor Fletcher says that *Bacon* will be welcomed by companies and by banks and other institutional lenders alike, for it ensures that, provided the company is motivated only by proper commercial considerations, it is possible for a company in economic difficulties to seek financial assistance, and to effect a security in exchange for the injection of fresh funds into the company, without the risk that the lender's security will be subsequently rendered voidable in the event of the company's insolvency.[96] He draws a distinction between payments by the insolvent to related parties which should be treated as unfair preferences and the orthodox commercial practice of a prudent lender taking a standard form of registrable security in the context of providing the funds for the company's continued efforts to trade through a period of crisis.[97] However, as indicated above, it favours banks and other financial institutions that can exert more pressure on a debtor to make a payment than trade creditors. It also appears to contradict the pari passu principle of equality.

[95] Section 588FA(3) of the Corporations Act.
[96] See note 80, 74.
[97] Ibid.

The High Court of Australia has previously held in other contexts that the supposed presumption, conclusive or otherwise, that a man intends the natural, or natural and probable, consequences of his acts, is unsatisfactory where a specific intent must be found.[98] Nevertheless, this notion played an important part in bringing about what ultimately was a legislative recognition that preferences were concerned with effect rather than with the intent of the debtor. In *Muntz v Smail*,[99] Griffith CJ asked:

> "[m]ust not a man be presumed to intend the natural consequences of his act?".[100]

This area provides one of the most striking differences between the law of Australia and the HKSAR in the area of unfair preferences. In both systems, whether the debtor has done something, which has the effect of putting the creditor in a better position than he would have been in, in the event of a winding up, is viewed objectively. To establish that a preference has been given one must ascertain whether there is a dislocation of the statutory order of priorities in relation to payment in a winding up. However, unlike their HK counterparts, Australian liquidators do not need to provide proof of any subjective element involved in the giving of preferences.

Unlike the HKSAR, Australia, which has similar anti-avoidance provisions, has moved to an objective “effects” test. It has been argued that whilst the shift of approach makes it easier to bring proceedings and more difficult for the creditor to refute the accusation of “unfair” advantage, such an approach, without more, will necessarily include transactions made in the ordinary course of business, and at a time

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[98] *Smyth v R* (1957) 98 CLR 163, 166-167.
[99] (1909) 8 CLR 262, 266, 271.
[100] This was in relation to s 73 of the Insolvency Act 1890 (54 Vict No 1102) which substantially corresponded to s 92 of the English Act of 1869, one of the statutory predecessors to the current preference provisions in UK.

when creditors might not have been aware of the company's insolvency.[101] In any event, an "effects" test cannot wholly do away with some element of motivation whether this is by way of defence or as part of the allegation made.[102]

According to one commentator,[103] if the UK changes its current test, which is the same as the HK test, it might serve as a disincentive to creditors to attempt to negotiate their claims outside the civil court process. This would discourage settlements which should be encouraged rather than litigation. A restrictive "effects" test has been criticised because it might serve to discourage the continuation of trade with a company perceived to be in financial difficulties.[104] It has been suggested that blanket avoidance, although one made subject to the creditor proving his good faith, would weaken and distort the principles underpinning the preference provision. The principle of respecting pre-insolvency transactions, in particular, would be altered significantly as assets disposed of the debtor prior to the onset of any formal insolvency regime would be recaptured more easily.[105]

On the other hand, the subjective "desire" test used by the HKSAR is open to criticism on the ground that it is out of touch with modern bankruptcy policy.[106] The test is not only difficult to apply but, to a great extent, it misses the point. The point is

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[101] Margaret Hemsworth, "Voidable preference: desire and effect", (2000) 16(2) *Insolvency Law & Practice* 54, 57.

[102] Ibid. For example, see s 122(2) of the Bankruptcy Act 1966 (Cth) which has an ordinary course of business and good faith defence. See also s 588FG of the Corporations Act (Cth) which has a good faith defence if a person had no reasonable grounds to suspect that the company was insolvent.

[103] See note 100 above.

[104] Ibid.

[105] Ibid.

[106] Anthony Duggan, "Canadian bankruptcy law reform: a selective research agenda", (2005) 13 *Insolvency Law Journal* 67, 78. He was referring to the UK test – the same can be said of the HK test given its origins.

that the transaction, if left intact, frustrates implementation of the policy of bankruptcy legislation, equitable treatment of all creditors (the pari passu principle). The fact that the debtor intended or did not intend this result should not be relevant. The actual or presumed intentions of the debtor when making a preferential transfer are not important. What is important is the effect that such a transfer has on the position of unsecured creditors with claims in bankruptcy or insolvency. The prime objective of bankruptcy and insolvency law should not be frustrated by a preferential payment or transfer which, by definition, results in material loss to the general body of unsecured creditors.[107]

In both jurisdictions, whether a payment by the debtor company has the *effect* of putting an unsecured creditor in a better position than he or she would have been in the event of a winding up, is viewed objectively. However, under the preference test in the HKSAR, the liquidator has to establish that the company which gave the preference was influenced in deciding to give it by a *desire* to improve the creditor's position.

Since the current HK provisions came into force on 1 April 1988, there have been no reported bankruptcy or insolvency cases dealing with payments to non-associates and unfair preferences.[108] A liquidator or trustee in bankruptcy has only been successful where the preference was given to an associate and the statutory presumption applied. Even where the statutory presumption applied, as in *Hau Po Man*, the majority of the

[107] Ibid.
[108] There have been only three reported cases: *Trustees of the Property of Hau Po Man Stanley (in bankruptcy) v Hau Po Fun Ivy* [2005] 2 HKC 227; *Re Phantom Records Ltd and Another* [2006] HKEC 2233; and *Re Asean Interests Ltd* [2005] HKEC 1539. The statutory presumption in s 50(5) of the *Bankruptcy Ordinance* applied as they all involved payments to associated persons.

Court of Appeal held that the presumption had been rebutted because the bankrupt's decision to make one of the payments was actuated by the moral pressure that had been brought to bear upon him by his sister and her husband. That finding was sufficient to displace the statutory presumption in relation to that payment.

Millet J in *Bacon* indicated that if a company is motivated by commercial considerations in paying a creditor, it is probable that the payment cannot constitute a preference. This defence was endorsed by the HK Court of Appeal in the *Hau Po Man* case. Another problem for HK liquidators is that a defendant to a preference action is also entitled to make out a defence on the basis that genuine pressure was exerted on the debtor and this precipitated the payment which is sought to be impugned. This means that liquidators have little or no chance of succeeding where creditors have applied pressure prior to receiving the preference. Le Pichon JA in *Hau Po Man* said that moral pressure can be every bit as real as commercial pressure.

Although section 50 of the *Bankruptcy Ordinance* has introduced changes to the law governing preferences, it is submitted that the practical effect of these changes could be minimal except where the onus of proof is reversed. This view is supported by the case law so far.

Policy

It is generally accepted that the rationale for the avoidance provisions is firstly, the need to ensure equality between creditors and secondly, deterring of the financial dismemberment of the debtor. The principle of pari passu distribution is based on an old equitable principle namely, that the assets of an insolvent are to be distributed equally and rateably among creditors. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. Equality and deterrence objectives are often regarded as joint rationales although these objectives sometimes conflict. For example, any exception for a payment on account of a pre-existing debt tends to favour the payee over other creditors and therefore may conflict with a policy of equal treatment. However, the good faith defence[109] available in Australia may benefit all creditors by deterring a free-for-all in the grabbing of the assets of the insolvent and enabling the insolvent to work its way out of its financial difficulties and continue operating its business.

Another objective of insolvency law is that rights created by parties in their pre-insolvency dealings will be respected in bankruptcy or liquidation.

According to Kirby J in *Sheahan v Carrier Air Conditioning Pty Ltd*[110], the unfair preferences provision is designed to protect creditors against any attempt to favour one creditor or a group of creditors over others during the time immediately before winding up. The payments to such creditors from the funds of the company necessarily reduce the amount of funds available to pay other creditors. The pari passu principle, which lies at the core of the administration of insolvency law, would be subverted. That principle is established to ensure that a company's available assets are shared with manifest equity among all of its unsecured creditors. Not just those with power over, or the ability to put pressure upon, the insolvent company.[111]

[109] Section 122(2) of the Bankruptcy Act 1966 (Cth) and s588FG of the Corporations Act (Cth).
[110] *Sheahan v Carrier Air Conditioning Pty Ltd* (1997) 147 ALR 1 at 41. Although this was obiter, there is a long line of authority to the same effect. In *Airservices Australia v Ferrier*, Toohey J indicated that '[o]ne of the fundamental precepts of corporate insolvency law is that the available assets of the company are to be shared rateably among its creditors': *Airservices Australia v Ferrier* (1996) 137 ALR 609 at 634.
[111] *Sheahan v Carrier Air Conditioning Pty Ltd* (1997) 147 ALR 1 at 41.

The Australian approach tends to favour the *pari passu* principle of equality over the principle of respecting pre-insolvency transactions. The preference provisions are perceived to be as much concerned with deterrence and the principle of pari passu as they are concerned with protecting and maximizing the asset base of the insolvent. However, given that there is no penalty for giving or receiving a preference, the deterrence principle is debatable.[112] It has been suggested that any economically rational creditor usually will decide to take a preference because the sanction of the preference law is the restoration of the status quo so that the creditor receives in the insolvency administration that which would have been received without the preference.

Conclusion

Although the HKSAR and Australia have the same policy rationale behind the preference provisions, the objective "effects" test in Australia clearly does not depend on the debtor's voluntariness and intention to prefer unlike the subjective "desire" test in the HKSAR.

The HK courts have followed Millet J's judgment in *Bacon* in interpreting the current preference test under section 50(4) of the *Bankruptcy Ordinance*. Unless this approach is reversed, it is submitted that creditors would be encouraged to bargain with the debtor company and to apply commercial pressure to secure preferential

[112] See s 588FI of the Corporations Act which provides that a creditor who gives up the benefit of an unfair preference may prove for the preferred debt.

payment in return for a promise of continued trading cooperation. This would allow deals to be done in which large or powerful creditors will be paid. Creditors with less bargaining power will not. This would not only fail to implement the long standing legislative policy against preferences but would seriously undermine the pari passu policy.

Compared with Australia, where there have been many cases in recent years, particularly involving preference claims, there have been few HK cases involving preference claims and even fewer cases which have been successful. While there may be a number of reasons for this, one commentator has concluded that since the seminal case of *Bacon* liquidators have little hope of attacking a preference except where the statutory presumption applies in relation to payments made by the debtor to an associate.[113] It is suggested that the reason for the greater use of the Australian avoidance provisions is that the majority of cases involve the preference provisions and historically, liquidators have been given more encouragement to issue proceedings because Australian courts employ an objective approach in considering whether a preference is voidable.[114] However, the small number of reported cases in the HKSAR is probably due to the demands placed on a liquidator in terms of proof. In contrast, in Australia, there are many preference claims made by liquidators and this is probably due, in part, to the fact that they are not hampered by the need to prove any subjective element on the part of the company.[115]

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[113] Andrew Keay, "The avoidance of pre-liquidation transactions: an Anglo-Australian comparison", (1988) November *Journal of Business Law* 515, 548. Keay was referring to UK liquidators but the same principle applies to liquidators in HK.
[114] Ibid.
[115] See note 112, 531.

In the HKSAR, except where liquidators can avail themselves of the presumption in section 50(5) of the *Bankruptcy Ordinance*, they appear to have little chance of attacking a preferential payment. This is based on the decisions delivered thus far by the HK courts. It is very difficult to establish the debtor's subjective state of mind and HK liquidators will often have problems in presenting evidence which is sufficient to prove their case. The requirement in the HKSAR to show that the debtor was influenced by a desire to prefer the creditor will complicate any claim made by a liquidator. In addition, HK liquidators are unlikely to be successful where creditors have applied pressure (moral or commercial) prior to receiving the preference.

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