DIRECTORS' DUTY NOT TO PREFER ONE CREDITOR TO ANOTHER

DIRECTORS owe their company a duty to act *bona fide* in the company's interests. When the company is insolvent, directors must consider the interests of creditors. The content of this duty, however, has never been clearly articulated. In particular, is a director in breach of his duty if he prefers one creditor to another? In *Moulin Global Eyecare Holdings Ltd. v Olivia Lee Sin Mei* (2014) 17 H.K.C.F.A.R. 466, Gummow N.P.J., sitting in the Hong Kong Court of Final Appeal, answered this question in the affirmative. This note (1) outlines the facts in *Moulin*; (2) considers the case law and the nature of the duty; and (3) compares the duty with the statutory preference provisions.

The defendant was a director of Moulin, a company with an apparently successful business. It later transpired that its accounts had been falsified, and in truth the company was insolvent. The company was wound up, and the liquidators made various allegations against the defendant. Of interest to us was the "Convertible Notes Loss" claim (at para. [10]). In essence, the liquidators alleged that the defendant knew or should have known of the fraudulent accounting practices, and should have "blown the whistle" (at para. [10]). Her failure to do so allowed the company to pay certain creditors for the early redemption of the relevant convertible notes.

The defendant applied to strike out the claim, arguing that even if she was in breach, the early redemption caused no loss to the company. The liquidators, on the other hand, relied on the duty to act *bona fide* in the interests of the company, which required the defendant to consider the interests of creditors when the company was insolvent. Emphasising the *pari passu* principle, the liquidators argued that the defendant had the duty to preserve the company's assets for *pari passu* distribution. In causing the company to make payments to a particular creditor, the defendant could be in breach of her duty to act *bona fide* in the interests of the company, and the company suffered a loss in that the company's assets available for *pari passu* distribution were dissipated.

The Court of Final Appeal (Gummow N.P.J. giving the only reasoned judgment) held that, in principle, the claim was reasonably arguable and should not be struck out. In so deciding, Gummow N.P.J. observed that (1) the duty to act *bona fide* in the interests of the company was not a proscriptive fiduciary duty; (2) the leading cases of *Kinsela v Russell Kinsela Pty. Ltd.* (1986) 4 N.S.W.L.R. 722 and *West Mercia Safetywear Ltd. v Dodd* (1988) 4 B.C.C. 30 turned on breach of proscriptive fiduciary duty and were distinguishable from the present case, which concerned breach of non-proscriptive duty; and (3) applying *Re HLC Environmental Projects Ltd.* [2013] EWHC 2876 (Ch); [2014] B.C.C. 337, a director who preferred one creditor to another could be in breach of the duty to act *bona fide* in the interests of the company. These three points merit further attention.

First, Gummow N.P.J. observed that the duty to act *bona fide* in the company's interests was not a "fiduciary" duty in its strict sense (at para. [35]). In contrast to the proscriptive fiduciary duty to avoid conflict of interests or secret profits, the duty was non-proscriptive and "a court of equity may be reluctant to intervene in the absence of sharp practice" (at para. [36]). Gummow N.P.J. thus saw the duty as a "non-proscriptive equitable" duty (at para. [57]) instead of a fiduciary duty. Similarly, Matthew Conaglen contended that the duty was not fiduciary in nature (Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Oxford and Portland 2010), 54–58).

This taxonomy debate has profound practical consequences. It has been suggested that third parties participating in the director's breach could not be made liable in knowing receipt or dishonest assistance unless the duty contravened by the director is fiduciary in nature. On this analysis, whether the third party is liable depends on the characterisation of the duty. Thus, in *The Bell Group Ltd. v Westpac Banking Corporation (No. 9)* [2008] WASC 239; (2008) 39 W.A.R. 1, it was argued that the duty to act in the company's interests was non-proscriptive and non-fiduciary, so that third parties could not be made liable (at para. [4434]). In response, Owen J. stated that the duty was a proscriptive fiduciary duty (the Court of Appeal observed that the duty might be non-proscriptive but was still fiduciary: *Westpac Banking Corporation v The Bell Group Ltd. (No. 3)* [2012] WASCA 157; (2012) 44 W.A.R. 1). Since Gummow N.P.J. characterised the duty as a non-proscriptive equitable (rather than fiduciary) duty, it may be argued that third parties could not be made liable. While this issue did not arise in *Moulin*, courts will definitely take Gummow N.P.J.'s analysis seriously. Nevertheless, both the proscriptive fiduciary duty and the duty to act in the company's interests are tools to control the fiduciary's exercise of discretionary powers. Preferring the fiduciary's personal interests and failing to act in the company's interests are often two sides of the same coin. Accordingly, third parties participating in the director's breach of either of these duties should be made liable in knowing receipt or dishonest assistance despite Gummow N.P.J.'s characterisation.

Second, Gummow N.P.J. suggested that *Kinsela v Russell Kinsela Pty. Ltd.* and *West Mercia Safetywear Ltd. v Dodd* were cases involving breaches of proscriptive fiduciary duties and had nothing to do with non-proscriptive duties. However, in *Kinsela*, Street C.J. expressly referred to the directors' "obligation to consider the interests of creditors" ((1986) 4 N.S.W.L.R. 722, 733), and in *West Mercia* Dillon L.J. referred to the payment made "in disregard of the interests of the general creditors" ((1988) 4 B.C.C. 30, 33). Gummow N.P.J.'s observation is thus puzzling.

Third, *Re HLC Environmental Projects Ltd.* concerned a director who made substantial repayments to one creditor in preference to the others, and the judge held that he was in breach of his duty to act *bona fide* in

the company's interests. Gummow N.P.J. accepted the validity of the decision, albeit without much discussion. While directors have to consider the interests of creditors in the context of insolvency, it can be argued that preferring one creditor to another causes no harm to the creditors as a group. Nevertheless, it is submitted that *Re HLC Environmental Projects Ltd.* was rightly followed. Insolvency law recognises that "creditors" are not a homogenous group. Thus, in dealing with a winding-up petition, insolvency law has no difficulty in distinguishing existing creditors from contingent creditors, or secured creditors from unsecured creditors. The conflicts among creditors are particularly serious in the insolvency context, as a payment to one creditor in full entails reduced recoveries for the others. This is precisely the kind of preference that insolvency law seeks to prevent. The court was thus right in holding that directors could be in breach by preferring one creditor to another, despite the fact that the creditors "as a whole" suffered no loss.

The directors' common law (i.e. case law) duty not to prefer one creditor to another has an obvious parallel with the statutory preference provisions (s. 50, Bankruptcy Ordinance (Cap. 6); s. 266B, Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)), which are based on the English preference provision (s. 239, Insolvency Act 1986). The common law duty however differs from the preference provisions in several respects. The liquidator brings the common law claim in the right of the company, and hence the proceeds can be captured by a charge that covers after-acquired property (Roy Goode, *Principles of Corporate Insolvency Law*, 4th ed. (London 2011), paras [6]–[35], [14]–[20]). In contrast, recoveries by virtue of the statutory provisions are for the benefit of unsecured creditors (Goode, ibid., at paras [6]–[36], [13]–[142]). Moreover, the common law targets directors instead of creditors (in that the common law makes the defaulting director accountable, whereas under the preference provisions, it is the preferred creditor, not the preferring director, who is liable), although as we have noted creditors may be made liable in knowing receipt or dishonest assistance.

Crucially, the common law claim offers several significant advantages. Most importantly, in *Re HLC Environmental Projects Ltd.*, Deputy High Court Judge John Randall Q.C. observed that, in determining whether the director was in breach, an objective approach could be adopted if a very material interest of creditors was unreasonably ignored, or if there was no evidence of actual consideration of the interests of the company ([2013] EWHC 2876 (Ch); [2014] B.C.C. 337, at [92]). This is in sharp contrast to the "desire to prefer" approach adopted by the statutory provision (s. 50(4), Bankruptcy Ordinance; s. 239(5), Insolvency Act 1986), which requires proof of the director's subjective wish to prefer (*Re M.C. Bacon Ltd.* [1990] B.C.C. 78). The statutory provisions have been much criticised, and the court's approach is clearly preferable. Second, the two-

year or six-month "relevant time" restriction (depending on whether an "associate", i.e. a connected person, is involved: s. 51, Bankruptcy Ordinance) does not apply to the common law claim. Lastly, since the common law right is vested in the company before the winding-up proceedings, the common law claim is a property of the company that can be assigned, while a statutory preference claim is not (*Re Oasis Merchandising Services Ltd.* [1998] Ch. 170). The funding issue that troubles many liquidators can be more easily resolved. Accordingly, the court's decision is to be welcomed.

Tom K.C. Ng*

*Address for correspondence: Brasenose College, Oxford. Email: ngkacheunghk@gmail.com.

THE FUTURE IS A FOREIGN COUNTRY

IN *R. (Lord Carlile) v Secretary of State for the Home Department* [2014] UKSC 60; [2014] 3 W.L.R. 1404, the Supreme Court held by a four to one majority (Lords Sumption, Clarke, Neuberger and Lady Hale, Lord Kerr dissenting) that the exclusion of an Iranian dissident from the UK was a proportionate interference with the Article 10 ECHR right to freedom of expression of both the dissident herself and the cross-party group of parliamentarians litigating on her behalf. The parliamentarians had wished to invite Mrs. Maryam Rajavi, the exiled leader of the former terrorist group the People's Mojahedin Organisation of Iran, to the Palace of Westminster to speak about democracy and human rights in Iran. The Home Secretary had excluded the invitee on the basis of a risk assessment formulated in cooperation with the Foreign Office. The risk assessment had concluded that admission of Mrs. Rajavi might endanger foreign relations between Britain and Iran, and British national security because of the potential risk to the safety of British diplomatic personnel based in Iran. Lord Sumption put the matter succinctly: "the future is a foreign country" and the Courts should therefore be reticent to interfere with Executive predictions in the realm of "high policy" (at para. [46]). The judgment is of great interest not only for its background facts, which concern the often fraught and complicated diplomatic relationship between the UK and Iran, but principally because the decision engages central constitutional questions regarding the institutional competence of the courts in judicial review.

The majority held that in judicial review of ministerial decisions which engaged Convention rights the court must give the decision-maker's conclusion appropriate weight, but remained entitled to reach an independent, final, and determinative decision according to the standard of proportionality. This judicial autonomy remained in matters of "high policy" such as making treaties, making war, dissolving Parliament, mobilising the armed