

CONTRACTUAL OBLIGATION IS NO EXCUSE FOR DISPOSITION OF PROPERTY IN A WINDING UP

HSIN CHONG CONSTRUCTION CO LTD (IN LIQUIDATION) V BUILD KING CONSTRUCTION LTD [2021] HKCFA 14

Background

Section 182 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance¹ (C(WUMP)O) provides that any disposition of the property of the company made after the commencement of its winding up shall be void unless the court otherwise orders. The Court of Final Appeal (CFA), in *Hsin Chong Construction Co Ltd (in liquidation) v Build King Construction Ltd*², clarified what would amount to a disposition of property for the purpose of section 182. This case shows that it may not be easy to identify the “property” and “disposition” in question. Further, it is important to seek a validation order prior to the disposition, rather than making the application retrospectively.

Facts

In 2013, Hsin Chong Construction Co Ltd (**Company**) and Build King Construction Ltd (**Build King**) formed an unincorporated joint venture to perform a Government contract to design and build a large police facility. Clause 17 of the joint venture agreement (**JVA**) provides that where one party becomes insolvent, the other may exclude the insolvent party from the joint venture. If the option to exclude is exercised, the continuing party shall continue to complete the project. At the completion of the project, an accounting exercise would be performed to calculate the amount of any accrued profit that the insolvent party would be entitled to up to the date of exclusion, taking into account the capital the insolvent party had contributed, less its share of any loss and any expenditure or loss incurred by the continuing party due to the insolvent party’s default.

In 2017 and 2018, when the joint venture was close to completing the design and construction of the structure of the police facility but the work on the architectural finishes and building services were just beginning, the Company fell into financial difficulties. In August 2018, a creditor issued a petition to wind up the Company (hence commencing the winding up of the Company). On 13

December 2018, having taken the view that the Company was insolvent, Build King invoked Clause 17 of the JVA to exclude the Company from the joint venture.

On 17 December 2018, Build King and the Company entered into a Supplemental Agreement (**SA**) whereby Build King agreed to pay a total of \$53.6 million to acquire the Company’s residual rights and interests in the joint venture. This in effect removed the need for the Company to await the final accounting at the completion of the project. The parties agreed that the consideration be paid in two tranches and into the bank account of Cogent Spring Limited (**Cogent Spring**), a sister company of the Company. The Company had evidently requested that payment be made to Cogent Spring as the Company’s bank accounts were frozen because of the winding-up petition.

In accordance with the SA, Build King paid the first instalment of \$20 million to Cogent Spring. Cogent Spring then used the monies to make payroll and MPF payments for the Company, as well as to meet other payment obligations of other entities in the same group.

On 18 January 2019, Build King applied for an order that the SA should not be avoided by section 182 of the C(WUMP)O.

The Court of First Instance (**CFI**) validated the SA and any disposition of property thereunder. This decision was upheld by the Court of Appeal (**CA**)³. However, the CFA overturned the CFI and CA decisions.

Decisions of the CFI and CA

In deciding in favour of validation, the CFI regarded Build King’s payment as a payment to the Company’s nominee to discharge Build King’s obligations as purchaser under the SA and hence not a disposition of the Company’s property. The CFI accepted that Cogent Spring merely received the monies on behalf of the Company and considered that section 182 of the C(WUMP)O was only

¹ Chapter 32 of the Laws of Hong Kong

² [2021] HKCFA 14

³ *Re Hsin Chong Construction Co Ltd* [2019] HKCA 1305

contravened because of the subsequent misapplication of the funds by Cogent Spring which was internal to the Company and/or its directors and did not involve any breach of duty on the part of Build King. The CFI was also concerned that the consequence of refusing validation would involve the Company having to repay \$53.6 million to Build King.

The CA also placed emphasis on the fact that Cogent Spring was designated as the Company's agent to receive the consideration from Build King on the Company's behalf under the SA and agreed that insofar as there was any contravention of section 182 of the C(WUMP)O, it would have been because of the subsequent misapplication of the proceeds by the Company and/or its directors and not Build King.

Decision of the CFA

The CFA set aside the validation orders made below and declared the SA and the dispositions made thereunder to be void by reason of section 182 of the C(WUMP)O. In doing so, the CFA clarified the principles regarding section 182 of the C(WUMP)O. If a transaction amounts to a disposition of a company's property made after commencement of the winding up, it is presumptively void unless the court otherwise orders. In deciding whether to validate the disposition, the court regards the interests of the general body of creditors as of central importance. Validation orders may be made where the disposition is likely to be or actually has been for the benefit of the unsecured creditors. Conversely, an order is likely to be refused if such benefit cannot be shown. If as a result of the disposition, the interests of the general body of creditors are prejudiced, such prejudicial effect prevents the disposition from being validated.

Applying the principles above, the CFA expressed disagreement with the decisions of the CFI and CA. The CFA held that the CFI and CA had put a wrong focus on Build King's payment of the monies to Cogent Spring. Pursuant to the JVA, when Build King exercised the right to exclude the Company, the Company was left with the rights to any accrued profits at the completion of the project. These residual rights and incidental interests constituted the initial property concerned. By the SA (which was entered into after the winding-up proceedings were commenced), Build King agreed to purchase the Company's residual rights and incidental interests under the JVA for a total consideration of \$53.6 million. The Company's residual rights and incidental interests were therefore converted into a contractual chose in action consisting of the Company's right to payment of the consideration under the SA. When Build King paid the first instalment of \$20 million to Cogent Spring pursuant to the SA, a disposition of the chose in action with the value of \$20 million took place. The fact that the sum of \$20 million was paid to a third party

pursuant to a contract does not prevent that transfer from constituting a disposition within the meaning of section 182.

The disposition concerned (i.e. the payment of \$20 million to Cogent Spring under the SA) was therefore presumptively void. As to whether it should be validated, the CFA noted that the value of the first instalment of \$20 million went entirely to Cogent Spring to be dissipated in favour of various third parties to the prejudice of the Company's unsecured creditors. As such, the validation orders made by the lower courts should be set aside. The CFA did not consider the facts that Build King had no ulterior purpose and did not breach any duty in making the payment to Cogent Spring as matters favouring the making of a validation order. Section 182 is there to ensure the Company's property is preserved for proper distribution and does not require it to be shown that the parties were involved in any breaches of duty before the disposition is rendered void.

Given that the validation orders were set aside and the SA was void, the CFA made it clear that the Company could revert to a claim against Build King for the value of its residual rights under the JVA as determined on a final accounting. As nothing was ever paid to the Company, there was no question of any repayment by the Company to Build King.

Takeaways

A company subject to a winding-up petition and any party seeking to enter into a transaction with such company should be aware of the implications of section 182 of the C(WUMP)O. In determining whether a transaction constitutes a disposition of the company's property and is rendered void under section 182 of the C(WUMP)O, it is crucial to identify the correct "property" and "disposition" concerned. A transaction performed in accordance with a contractual provision can still be avoided by section 182 of the C(WUMP)O if as a result of that payment, the company's property is transferred or dissipated so that the interests of the general body of creditors are prejudiced. Such prejudicial effect prevents the transaction from being validated.

In particular, banks in Hong Kong will usually freeze a company's bank account once it is made aware of a winding-up petition against the company. Any party seeking to make payment to such company should apply to the court for a validation order in advance, rather than attempting to circumvent the problem of the company's frozen bank accounts by making payment to entities associated with the company and seeking a retrospective validation order afterwards. In taking the latter course, the party takes the risk of the court refusing to make a retrospective validation order, and the transaction being rendered void.

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