New Insolvency Law: Traps and Gaps

Philip Smart and Charles D Booth argue that poor drafting in Hong Kong’s new insolvency law leaves many issues open to challenge.

Corporate and insolvency law practitioners will be aware that on a number of occasions in recent years poor legislative drafting has resulted in defective amendments being made to the Companies Ordinance (Cap 32). This problem has recently reared its head again, most notably in Re Setaffa Investments Ltd [1998] 2 HKLRD 236 (Le Pichon J). As in previous examples, the difficulties revealed in the Setaffa case were created because the draftsman, when in effect copying UK legislation, did not do a thorough enough job and failed to copy fully the UK legislation. As Le Pichon J noted (at 246), such an oversight would ‘hardly be the first time that it will have occurred when Hong Kong legislation is modelled on UK legislation.’ The purpose of this article is threefold: (1) to note the decision in Setaffa; (2) to identify a number of other areas in the new insolvency legislation where similar problems have occurred; and (3) to bring to practitioners’ attention a practical difficulty concerning the extraterritoriality of the new avoidance powers that have recently been incorporated into the insolvency legislation.

Setaffa and Post-Liquidity Interest

Major amendments to Hong Kong’s insolvency regime were made in the Bankruptcy (Amendment) Ordinance 1996 (Ord No 76 of 1996) (the BAO), which finally came into operation on 1 April 1998 (LN 158 of 1998). One issue dealt with in the BAO is interest on debts in a bankruptcy. However, reform of the law on interest on debts in relation to a solvent liquidation was introduced directly into the Companies Ordinance by the Companies (Amendment) Ordinance 1997 (the CAO), which came into operation on 10 February 1997 (Ord No 3 of 1997). The CAO introduced a new s 264A into the Companies Ordinance. This section deals inter alia with interest on debts, in the post-liquidation period, owed by a company that is not insolvent. Subsection (2) provides that ‘...any surplus remaining after the payment of debts proved in a winding up of a company which is not an insolvent company:

... shall, before being applied for any other purpose, be applied in paying interest on those debts in respect of the period during which the debt has been outstanding, in the case of ...

(b) a voluntary winding up, since the commencement of the winding up ...

It goes without saying that s 264A will be applicable where the liquidation has commenced after 10 February 1997. The issue raised in Setaffa, however, was whether the section operated in relation to a winding up commenced prior to that date.

In Setaffa the winding up had begun many years previously (in fact as long ago as 1983), but there remained a substantial sum of money which had not been distributed at the time s 264A came into operation. It was argued that s 264A could be given a partially retrospective operation by applying it to distributions taking place after 10 February 1997. The reason why this argument, however unlikely it may appear, could even be advanced is because although s 264A(2) is taken almost verbatim from the Insolvency Act 1986 (UK) (s 189 thereof), the draftsman in Hong Kong failed to copy the relevant transitional provisions. These provisions, contained in the 1986 Act, Sch 11, para 4(1), provide:

‘In relation to any winding up which has commenced, or is treated as having commenced, before the appointed day, the new law does not apply, and the former law continues to have effect ...’

Clearly, some such transitional provision ought to have been made in the CAO. The failure to do so, which as Le Pichon J suggested (at 246) may have been ‘attributable to sheer oversight’, led to (what should have been) quite unnecessary litigation. On the facts in Setaffa, the court rejected the contention that s 264A had any retrospective effect. For in the absence of any express language or clear indication suggesting retroactivity, the section only applied to liquidations commenced after 10 February 1997.

Transitional Problems and Avoidance Powers

Under s 99 of the BAO (unlike the CAO) there is a general transitional provision which, in effect, provides that where a bankruptcy case had already commenced prior to the coming into effect of the BAO (ie 1 April 1998) the ‘old law’ will continue to apply to that case (subject to certain important exceptions in relation to the discharge of bankrupts). Thus, if we turn to the avoidance powers of a trustee in bankruptcy, there can be no doubt that if, for example, the bankruptcy commenced on 1 March 1998, then the old law on fraudulent preference will be applicable should the trustee seek to...
set aside a payment made by the bankrupt on 1 January 1998. In other words, as in *Setaffa*, the new law is not retrospective. But, one may ask, what of the situation where the bankruptcy is commenced after 1 April 1998 — so s 99 of the BAO is not applicable — but the transaction sought to be impeached was entered into prior to that date? The trap is to assume that, because the case commenced after 1 April 1998, the new provisions will apply.

The way this issue was specifically resolved in the Insolvency Act 1986 (UK) was to have a special transitional provision relating to avoidance powers (see para 17 in Sch 11 to the 1986 Act). That provision stated that a transaction occurring before the appointed day would only be avoided under the new statutory provisions to the extent that such a transaction could have been avoided under the old legislation. The advantage of this approach is that it puts the focus on the new provisions but, at the same time, prevents any unfairness by not allowing the new provisions to apply where the transaction was unimpeachable (under the old law) at the time it was entered into.

In Hong Kong, however, the draftsman has not copied para 17. As a result, as with the *Setaffa* case, there is no expressly applicable statutory provision in the amending legislation. Nevertheless, basic principles tell us that, in the absence of an express provision or a clear indication, the new avoidance powers cannot be regarded as applying to transactions taking place prior to 1 April 1998. If it were otherwise, a transaction that was perfectly valid and unimpeachable at the time it was entered into might subsequently become voidable. If, as suggested here, the new avoidance powers do not apply, then does the old law continue to operate in respect of such transactions? In light of s 23 of the Interpretation and General Clauses Ordinance (Cap 1), the answer is in the affirmative. Hence, the old avoidance provisions, even though they have been repealed by the BAO, must continue to be applied in relation to transactions occurring before 1 April 1998 despite the fact that the bankruptcy proceedings only commence after that date.

In summary, practitioners should be aware that the new avoidance powers in bankruptcy cases are not retrospective and, moreover, that the old provisions continue to apply to events and transactions occurring prior to 1 April 1998 even where the bankruptcy was only in fact commenced after 1 April 1998. Thus, practitioners had better keep copies of the old provisions for some years to come.

**Our only observation is that the total non-discussion of this important topic by the appropriate law reform body is a peculiar way of conducting a law reform exercise**

**Unfair Preferences under the Companies Ordinance**

The BAO not only introduced new avoidance powers in bankruptcy, it also added a new unfair preference provision to the Companies Ordinance. Section 266B contains the following transitional provision:

‘(2) Where the winding up of a company commences before the amending Ordinance comes into operation, the provisions of the principal Ordinance [that is, the Bankruptcy Ordinance] as it existed before being amended by the amending Ordinance apply in respect of sections 266 and 266A of this Ordinance.’

Hence, s 266B(2) expressly provides that where a winding up commences before 1 April 1998, the new unfair preference provision does not apply. The effect, therefore, is that the old fraudulent preference provision (found in the old bankruptcy legislation) remains applicable. Section 266B(2) however does not address the situation where, for example, the winding up commenced on 1 May 1998 but the alleged preference occurred on 1 January 1998. Nevertheless, there can be no doubt that s 266B has no retrospective effect whatsoever: events taking place before 1 April 1998 continue to be governed by the old law on fraudulent preference.

**Extraterritoriality: Amendment of Insolvency Rules Required**

As has been noted, the new avoidance powers under the BAO are based largely on the equivalent English provisions (see ss 339 et seq of the Insolvency Act 1986). In recent years the English courts have consistently maintained that these English avoidance powers may operate extraterritorially (see *Re Paramount Airways Ltd (in admin)* [1993] Ch 223 and generally, *P Smart, Cross-Border Insolvency* (2nd Ed, 1998), pp 17-27. Note the same view is taken in England in relation to the public examination of a director of an insolvent company (see *Re Seagull Manufacturing Co Ltd* [1993] Ch 345). Having regard to the ancestry of the BAO provisions, it is very likely, if not inevitable, that the Court of First Instance would take the same approach in relation to the new Hong Kong avoidance powers. This would represent a change to the pre-April 1998 position, where avoidance powers were generally taken to be territorial in nature (see obiter in *American Express International Banking Corp v Johnson* [1984] HKLR 372).
Obviously, in light of the realities of global business, there is every reason to expect present-day avoidance powers to be construed as extraterritorial.

It is unfortunate that insolvency practitioners do not have the benefit of the views of the Hong Kong Law Reform Commission or its Insolvency Sub-Committee on the question of the extraterritoriality of the new avoidance powers. It is quite startling to realise that, despite the obvious significance of avoidance powers in bankruptcy, no discussion of avoidance powers is found in either of the two law reform documents relating to bankruptcy. The Law Reform Commission, and its Sub-Committee on Insolvency, simply did not address avoidance powers at all in these documents. Nevertheless, the UK provisions found their way into the Bankruptcy (Amendment) Bill 1996 and from there into the BAO. These commentators are happy to see new, more powerful avoidance powers conferred upon trustees and liquidators in Hong Kong insolvencies. Our only observation is that the total non-discussion of this important topic by the appropriate law reform body is a peculiar way of conducting a law reform exercise.

It is perhaps tempting to overlook the process followed and focus on the end result. Hong Kong trustees and liquidators now have stronger avoidance powers and these powers are, it seems, extraterritorial. However, if what the draftsman was trying to achieve (as one must assume) was to confer the same avoidance jurisdiction upon a Hong Kong trustee and the Hong Kong court as is possessed by their English counterparts, then that objective has not been met. For when the substantive law was changed in England in the mid-1980s, new procedural rules were introduced in the form of the Insolvency Rules 1986. Specifically, r 12.12(3) leaves it entirely to the discretion of the court as to the manner in which any process or order of the court in insolvency proceedings is to be served on any person who is not in England. Thus, the position in England is that: (1) the Insolvency Act 1986 avoidance powers are extraterritorial in scope; and (2) a person outside the jurisdiction can be served with process by reliance upon the express wording of r 12.12 of the Insolvency Rules 1986 (for a recent illustration involving insolvent trading, see Re Howard Holdings Inc [1998] BCC 549 and P Smart, supra pp 26-27). However, in Hong Kong, although the new avoidance powers are copied from the UK provisions, no equivalent to r 12.12 has been introduced into either the Companies (Winding-up) Rules or the Bankruptcy Rules (even though extensive amendments were made to the Bankruptcy Rules as from 1 April 1998 (Bankruptcy (Amendment) Rules 1998 (LN 77 of 1998)). The net result is that, although the new avoidance powers are extraterritorial, most practical benefits that might have flowed from extraterritoriality have evaporated because of what was presumably an oversight in not making appropriate procedural provision in the Bankruptcy Rules and the Companies (Winding-up) Rules.

Conclusion
The Setaffa decision puts to rest any suggestion that reference to this sort of legislative drafting error is mere quibbling. The failure to adequately copy UK legislation creates uncertainty and invites unnecessary litigation. To avoid similar confusion as to the operation of the new avoidance powers, it would be helpful if the Government Printer were to include copies of both the old and new provisions in the next edition of the inserts for the Bankruptcy and Companies Ordinances. Finally, it is also important that amendments be made to the subsidiary legislation as soon as possible to enable trustees and liquidators to benefit from the extraterritoriality of their new avoidance powers.

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破產案中的新的
廢止權力並無適用
而舊有條文將繼續適用
在 1998 年 4 月 1 日前
發生的事件及交易

聯合國《1988 年破產清盤法令》特別
處理這項問題，方法是將有關廢止權力的
廢止條文（見該法令第 17 條）。該
條文規定，一宗在指定日期前進行的交易，
在被廢止時可根據將廢止條文及廢止條文
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**At Issue**

法律改革委员会及其破产清盘附属委员会对废止律例之废止权之审议。另一方面，《1996年破产（修订）条例草案》以及《破产法修订条例》中包括了联合国王国法例的条文。

香港的破产受案人及清盘人可被赋予更新、更有效的废止律例，这对香港人无疑感到高兴。我们唯一的愿望是，有关的法律改革组织在推行改革时对这重要项目竟然完全不作讨论，这实在是一件奇怪的事。

**有關的附属法例必须赶快被修订，以使破产受案人及清盘人可真正从新的废止律例的权力中获益**


**緒論**

《破产法（修订）条例草案》的内容，显示了对于此新法例草案增加的评论，应非吹毛求疵。有关草案者未有完全地把联合王国法律例抄过来，但这不但产生了灰色地带，而且更引致了不必要的困难。

为了避免在香港的废止判决的运作上出现类似的问题，政府应考虑在《破产法令》及《公司条例》下一期的插画上同时包括新旧两套条文。然后，有关的损害法例必须赶快被修整，以使破产受案人及清盘人可真正从新的废止判决的权力中获益。

Philip Smart及Charles D Booth
均在香港大学教授破产清盘法