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POTENTIAL COSTS EXPOSURE FOR DIRECTORS OF AN INSOLVENT COMPANY WOUND UP IN HONG KONG FOR CAUSING THE COMPANY TO OPPOSE A WINDING-UP PETITION

To Our Clients and Friends:

In making a winding-up order against Carnival Group International Holdings Limited (the "**Company**"), Hong Kong Court emphasizes the importance for the directors of an insolvent company to carefully consider whether they should procure the company to oppose the winding-up petition otherwise they could be personally liable to pay costs arising from the opposition.[1]

The Hon Linda Chan J ordered the winding up of the Company after hearing the petition (the "**Petition**") presented in March 2020 by one of the unsecured creditors of the Company (the "**Petitioner**"), which the Company opposed on the basis that there were pending restructuring proposals. The Court noted that there is a duty on the directors to protect and safeguard the interests of the unsecured creditors. In circumstances where the directors became aware that the restructuring proposals would not come to fruition, it would be incumbent upon them to cause the Company to be wound up. As the directors had failed to do so and incurred costs to oppose the Petition, the Court considered that it may be appropriate to make an adverse costs order against the directors personally, and they were directed to file evidence/submissions to demonstrate why they should not be liable. After considering the directors' submissions, the Court ordered that the four directors who remained in office on the date of the winding-up order to be personally liable for the costs of and occasioned by Company's opposition to the Petition at the hearing before the Hon Linda Chan J on 23 August 2022.[2]

1. Background

The Company was listed on The Stock Exchange of Hong Kong. It was incorporated in Bermuda and, until its being wound up, had since February 1994 been registered as an oversea company in Hong Kong under the former Companies Ordinance. The Company was an investment holding company and held a number of subsidiaries incorporated in Hong Kong, the Mainland and the BVI (together, the "**Group**").

Since 2018, the Company and the Group had been in financial difficulty and they were unable to meet their debts using the income generated from the business. As at 31 December 2019, the Company's net liabilities were HK$1 billion, and the total outstanding interest-bearing debts of the Group (consisting of both secured and unsecured debts) was RMB 7.6 billion.

The Petitioner was a holder of a number of unsecured bonds (with an outstanding principal of over HK$30 million at the date of the Petition) which the Company had defaulted. The Petition was supported by other unsecured creditors (the "**Supporting Creditors**") to whom an aggregate amount of over

HK$878 million was owed by the Company. In addition, one of the 12 institutional (and secured) creditors which had in the past signed letters to support an adjournment of the Petition also indicated support of the Petition before the hearing. No creditor had filed any notice to oppose the Petition.

2. Winding-up order made by the Court

The Petition averred, among other things, that the three core requirements for the Court to exercise its discretionary jurisdiction to wind up the Company were satisfied.[3] Even though in all of its affirmation filed in opposition to the Petition, the Company did not dispute such averments and only relied upon the ground that there had been ongoing restructuring effort which, if implemented, would result in higher return to the unsecured creditors, the Company sought to contend at the hearing (held on 23 August 2022) that the second core requirement (i.e. there must be a reasonable possibility that the winding-up order would benefit those applying for it) was not satisfied.

The Court held that it was not open to the Company to raise the jurisdictional challenge 2.5 years after the Petition was presented and, in any event, there was no merit in such argument.

The Court also noted that there was no evidence to show that the Company had made any real effort in pursuing the restructuring proposals, and that the history of the matter showed that the Company had used the so-called restructuring effort to obtain multiple adjournments and yet failed to comply with a number of orders requiring the Company to file affidavit evidence to deal with the progress of such restructuring.

In the circumstances, the Court was satisfied that it should exercise its discretionary jurisdiction under s.327(3) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("**CWUO**") and made a winding-up order against the Company.

3. Duty of the directors of an insolvent company and potential costs order against the Company's directors

The Hon Linda Chan J emphasized that the directors of an insolvent company are duty bound to (a) consider whether there is any reasonable prospect of the company avoiding going into insolvent liquidation, and (b) take step to put the company into liquidation where there is no viable restructuring proposal supported by the requisite majorities of creditors. Such duty is enshrined in the avoidance provisions under the CWUO (such as s.266, which renders debts paid subject to unfair preferences voidable, and s.275, which imposes liability on directors for fraudulent trading). Where a company is insolvent or of doubtful solvency, the directors in carrying out their duty to the company must take into account the interests of the creditors, which should be regarded as paramount. This is because the interests of the company are in reality the interests of the creditors, whose money is at stake.

The Court held that it must have been clear to the directors of the Company, who were said to be in discussion with the institutional creditors concerning the restructuring proposals, that there was no reasonable prospect for the Company to be able to implement any proposals to compromise its debts so as to avoid liquidation. As soon as they became aware that the restructuring proposal would not be implemented, the directors should have taken step to cause the Company to be wound up so as to protect

and safeguard the interests of the unsecured creditors. When pressed upon by the Court, the Company was unable to identify any justification as to how it was in the interests of the Company and the creditors to oppose the Petition, mindful of the Company's insolvent state, the directors' duty to protect the interests of the creditors and the lack of any viable restructuring proposals.

4. Adverse costs order against the directors

The Court further criticized the directors for causing the Company to continue to oppose the Petition by raising the jurisdictional challenge that was devoid of merits. The Court concluded that it may be appropriate to depart from the usual costs order (which is that the costs of the Petitioner and one set of costs for the Supporting Creditors be paid out of the assets of the Company) and to consider ordering the directors to pay for the costs of and occasioned by the Company's opposition to the Petition from the time when they became aware that the restructuring proposals would not be implemented. The directors of the Company were joined as respondents to the Petition for costs purpose only, and the Court directed them to file and serve evidence and/or submission to explain why they should not be liable for costs.

Upon considering the submissions subsequently filed by the six relevant directors, the Hon Linda Chan J concluded that there was no basis for them to cause the Company to oppose the petition on jurisdictional ground, which was advanced as the only ground in opposition to the Petition at the 23 August 2022 hearing.

The Court ordered three Independent Non-Executive Directors and an Executive Director, who were directors of the Company at the materials times and who remained in office on the date when the Company was ordered to wind up, to pay to the Petitioner, the Supporting Creditors (with one set of costs) and the Official Receiver their costs of and occasioned by the Company's opposition to the Petition at the hearing on 23 August 2022. As to the two Executive Directors who had ceased to be directors of the Company from 4 September 2021 and 15 May 2021 respectively, the Court was satisfied that after their resignation, they were not involved in causing the Company to oppose the Petition, and hence they were not ordered to pay the costs occasioned by such opposition.

5. Conclusion

This judgment serves as a useful reminder of the directors' duty where a company is insolvent or of doubtful solvency. When discharging their duty, directors of an insolvent company must consider the creditors' interests as paramount and take those into account in exercising their discretion. They are duty bound to consider whether there is any reasonable prospect of the company avoiding insolvent liquidation, and should take step to wind up the company where there is no viable option.

If the directors fail to discharge such duty and yet cause the company to oppose a winding-up petition unreasonably, they may face adverse costs consequence and may be held liable for the costs of and occasioned by opposing the winding-up petition.

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[1] *Re Carnival Group International Holdings Limited* [2022] HKCFI 2668, available here.

[2] *Re Carnival Group International Holdings Limited* [2022] HKCFI 3097, available here.

[3] Please refer to paragraph 2 of our client alert "Hong Kong Court of Final Appeal Confirms That 'Leverage' Satisfies the 'Benefit' Requirement for Winding Up Foreign Companies", available here, for an explanation of the three core requirements.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, or the authors and the following lawyers in the Litigation Practice Group of the firm in Hong Kong:

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