UNDUE PREFERENCE

Introduction

When a company enters financial difficulty, it faces conflicting interests. On the one hand, it must continue with commercial transactions to preserve and hopefully rehabilitate the company; on the other, it must respect its creditors' rights by not making payments which may be seen as preferring certain creditors. It is this balance which the law of undue preference seeks to strike.

In *Chee Yoh Chuang and Anor (as Liquidators of Progen Engineering Pte Ltd) v Progen Holdings Ltd* [2010] SGCA 31, the Singapore Court of Appeal dealt with the issue of undue preference where an insolvent company made large payments to certain creditors while seemingly ignoring other creditors. Since the main recipient of the payments was related to the insolvent company, the transaction was statutorily presumed to be fueled by the desire to prefer that creditor. On the facts, the Court found that the Respondent had failed to rebut this presumption, and indeed, the evidence showed that the transactions in question were made with a desire to prefer the Respondent.

This case demonstrates the operation of the statutory presumption of the desire to prefer, and also shows how the Court may resolve the inherent conflict between preservation of the company and the interests of its creditors. The Court of Appeal also set down guidelines as to the duties of directors when a company approaches insolvency.

Brief Facts

(1) Progen Engineering Pte Ltd ("PEPL"), Progen Pte Ltd ("PPL"), and the Respondent were all part of the Progen Group. At the relevant time, the Respondent and PEPL shared three common directors, including Lee Ee, who along with his wife owned 29.4% of the Respondent's issued shares.

(2) After a winding up order was made against PEPL, its liquidators applied to Court for the return of substantial amounts of monies paid by PEPL to the Respondent on the basis that they constituted unfair preferences.

(3) The largest transaction involved the repayment of a loan of about S$11 million to the Respondent on 4 February 2005. The Respondent sought to justify the repayment of the loan by alleging that it had proper commercial considerations for doing so, as the repayment was for the purpose of making a capital distribution to the Respondent's shareholders, which had been approved by the Court and by the shareholders at an EGM

(4) There were also a number of other transactions ("the other transactions") which the liquidators sought to set aside.

    a. More than S$7 million was set-off from the debt of PPL to PEPL against the debt of PEPL to the Respondent.

b. PEPL transferred funds to the Respondent for payment of salaries and expenses of the Respondent's employees, and also as reimbursement for iron ore purchases, allegedly as part of settled practice.

(5) PEPL's directors issued PEPL's balance sheet and financial statement, as well as a statement made by two of PEPL's directors, on 23 February 2005. These statements contained several material misstatements.

a. PEPL's financial statements unequivocally stated that PEPL's debt to the Respondent was not expected to be repaid within the next 12 months.

b. The statement issued by PEPL's directors indicated that PEPL would be able to pay its debts as and when they fall due as the Respondent had agreed to provide adequate funds for PEPL to meet its liabilities, and to subordinate amounts owing to it for prior payment of other liabilities.

c. Contrary to these statements, $10,987,960.85 had already been repaid to the Respondent on 4 February 2005, and further sums continued to be repaid.

Issues

It was common ground that the presumption of unfair preference arose on the facts, since the Respondent and PEPL were clearly connected through common directors, and the payments were made within 2 years of the commencement of winding-up proceedings.

Therefore, the primary issue before the Court of Appeal was whether the Respondent could show that the payments were not influenced by the desire to prefer, thus rebutting the presumption of unfair preference.

Holdings Of The Court Of Appeal

The Court of Appeal held that the Respondent had failed to prove that the payments were not influenced by the desire to prefer. In fact, the Court found there was irrefutable evidence that the payments were indeed prompted by the desire to prefer the Respondent over other unrelated creditors.

General law

The Court commented on the need to balance the rights of creditors, on the one hand, and genuine attempts by directors to resuscitate a company in financial difficulties on the other. It stated that the Court would not be too quick to act where directors are acting in good faith to preserve or rehabilitate the company. However, where related parties have benefitted from priority payments, the law would view these transactions with a good measure of skepticism, particularly if the interests of unrelated creditors are simultaneously ignored.

In such a case, the burden of proof is placed squarely on the related party which has received such payments to show that there had been no undue preference.

(i) It must thus be proven, on a balance of probabilities, that the transaction had not been influenced *at all* by the desire to place the related party in a better position in the event of company's winding up than if the transactions had not been entered into.

(ii) It is insufficient for the director to simply deny the existence of such a desire to prefer. The facts must be explained in detail.

The main transaction

With regard to the return of the $11 million loan to the Respondent, the Court found that the objective facts buttressed the statutory presumption of the desire to prefer, rather than rebutting it.

The Court held that the directors had made false assurances (both in PEPL's financial statements and in the directors' statement) that the loan would not be repaid and that the directors' subsequent (and prior) breach of these assurances was compelling evidence of a desire to prefer the Respondent.

(i) Winter Engineering had secured an arbitration award of S$3.6 million against PEPL in November 2006. If enforced, PEPL would have been insolvent, and would likely have been placed in liquidation.

(ii) It was only because of the false assurances that creditors such as Winter Engineering did not enforce their outstandings, allowing PEPL to continue trading as a going concern.

(iii) Subsequent events clearly showed that PEPL never intended to settle the outstandings due to its unrelated creditors. After the issuance of the misstatements, PEPL transferred around S$21.5 million to the Respondent and other related companies, but paid nothing to its two largest external creditors (one of which was Winter Engineering).

(iv) The Court came to the "irresistible conclusion" that these false assurances must have been given to buy more time for the Respondent to transfer PEPL's monies to itself and to related creditors, away from the reach of PEPL's unrelated creditors.

The statutory presumption was further reinforced by the breach of personal duties on the part of PEPL's directors.

(i) When a company is insolvent, its directors have a fiduciary duty to take into account the interests of the company's creditors when making decisions for the company. This duty reflects the same policy objectives as the provisions in insolvency law allowing for the avoidance of unfair preferences and/or transactions at an undervalue. Both are aimed at protecting the general body of creditors against a diminution of the assets available for distribution to creditors in the collective insolvency regime. The Court should view with even greater skepticism transactions that appear to

undermine the collective procedure of insolvent liquidation e.g. unfair preferences or under value transactions. The breach of such fiduciary duties should throw even greater doubt on the legitimacy of impugned transactions.

(ii) Here, the S$11 million had been returned to the Respondent for capital distribution. On the facts, Lee Ee and his wife (both directors of PEPL) owned 29.24% of the Respondent's shareholding and, as such, were the ultimate beneficiaries of a substantial portion of the payment of S$11 million.

(iii) Taking into account these facts, the Court held that there was a compelling inference that Lee Ee and his wife were the directing minds behind the payment. This breach of duty stood as irrefutable evidence of their desire to prefer the Respondent.

The Court also found that the Respondent's argument that there were proper commercial considerations motivating the payment was without merit, and insufficient to rebut the statutory presumption.

(i) While the alleged higher interest rates in PEPL's fixed accounts could explain why the money was *initially transferred to PEPL*, it did not explain why the money was *repaid to the Respondent*.

(ii) Once the money was transferred to PEPL, it was an unsecured loan which could not be repaid in priority relative to other outstanding liabilities when the company was insolvent.

The other transactions

These can be summarised as follows:

	Date	Amount (S$)	Type of Transaction
a.	31/01/2005	92,994.50	Salaries, etc
b.	21/02/2005	50,000.00	Purchases of iron ore
c.	28/02/2005	57,837.00	Salaries, etc
d.	04/03/2005	55,000.00	Purchases of iron ore
e.	31/03/2005	48,956.75	Salaries, etc
f.	30/04/2005	48,607.00	Salaries, etc
g.	31/05/2005	48,617.62	Salaries, etc
h.	30/06/2005	50,131.29	Salaries, etc
i.	30/06/2005	7,538,243.15	Set-off

With regard to these other transactions, the Respondent argued that they were not unfair preferences as they were part of PEPL's settled practice as PEPL had been acting as "payment central" to make payments to other related companies within the Group. However, the Court rejected this argument.

(i) It does not follow that the presumption of the desire to prefer will be rebutted simply because a transaction had been earlier carried out while a company was solvent.

(ii) "Past practice" is only relevant if those practices show that the creditor has been providing new value to the company to keep the company's business going, thus showing a motivation to obtain fresh finance or value rather than a desire to prefer.

In these transactions, the payments to the Respondent did not arise out of arrangements from which the Respondent could be said to have provided new value to PEPL.

(i) PEPL's payment of the salaries of the Respondent's employees (transactions a., c., and e. to h.) did not arise out of the Respondent's provision of new value or credit to PEPL.

(ii) The commercial reasoning behind PEPL's reimbursements to the Respondent for the iron ore purchases (transactions b. and d.) was not substantiated with documentary evidence. Particularly, there was no evidence that these payments were made to obtain fresh financing from the Respondent for iron ore purchases.

(iii) The set-off transaction (transaction i.) did not provide new credit, and there was no evidence of an established past practice of such payments. Such a transaction clearly placed the Respondent in a better position in the event of PEPL's insolvent liquidation than if the transaction had not been done. The inference is that PEPL intended to prefer PPL and the Respondent.

The Court's Orders

Therefore, the Respondent failed to rebut the presumption that PEPL's payments were made with the desire to prefer the Respondent. The court found that the directors' manifest breaches of their personal directors' duties reinforced the statutory presumption. The Respondent was ordered to repay to the liquidators all monies required to settle debts to unrelated creditors up to a sum of S$18,514,287.97, being the amount of debt owed by PEPL to the Respondent. Further, Lee Ee was ordered to personally bear the legal costs and expenses of the proceedings in view of his flagrant breaches of assurances in PEPL's financial statements and his egregious misrepresentations to the Court in misleading it into approving the capital distribution of the Respondent.

Concluding Words

In reversing the High Court's decision, the Court of Appeal demonstrated that it will embark on a full and proper analysis of all the surrounding circumstances so as to ascertain the subjective intention behind transactions which are alleged to be unfairly preferential, and that the Court will not blindly accept empty commercial justifications thrown up in an attempt to explain such transactions. When an insolvent company chooses to make payments to related creditors over unrelated creditors, it must be able to clearly prove that such payments were not motivated by a desire to prefer.

The Court also highlighted the duty of directors to take into account the interests of the company's creditors in times of insolvency. This is not only a matter of personal liability, but may also affect the legitimacy of alleged unfair preference transactions. By holding Lee Ee personally liable for the

costs of proceedings, the Court sent a strong message as to its disapproval of the misuse of one's position as director for personal gain in times of financial difficulty.

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