

Construction Companies in Liquidation: Who Owns the Retention Money?

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A recent decision of the Hong Kong Court of Appeal² arising out of the liquidation of Hsin Chong Construction Company Limited (Hsin Chong) raises two important issues that often arise in the context of a company under liquidation:

1. To what extent may liquidators seek the Court's guidance under section 200(3) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance, Cap. 32 (s.200(3) CWUMPO)?
2. Do retention monies received by a construction company in respect of nominated sub-contractors (NSCs) form part of the estate of the contractor in a liquidation scenario?

Background

In August 2018, Hsin Chong, one of Hong Kong's oldest construction companies, became insolvent and provisional liquidators were appointed over it (the PLs).

The PLs embarked on the arduous task of reigning in the outstanding monies owed to Hsin Chong under the numerous building and engineering projects on which it was engaged, as well as fending off claims from multiple sub-contractors and service providers eager to get paid for their hard work.

One project which Hsin Chong was in the process of closing out when it became insolvent was the construction of two student hostels for the Chinese University of Hong Kong (CUHK), on which Hsin Chong was the main

contractor with a number of nominated sub-contractors (the NSCs) under it.

The Architect's final certificates (issued after the date of insolvency) provided that an outstanding balance of HK\$8.1 million was due to Hsin Chong from CUHK, of which approx. HK\$1.9M was due to the NSCs, partly for retention monies and partly for non-retention monies.

The PLs accordingly demanded that CUHK pay the outstanding HK\$8.1 million. CUHK proposed to the PLs that, with respect to the HK\$1.9M owned to the NSCs, it bypass Hsin Chong and make direct payment to the NSCs. The PLs declined this proposal, but undertook to set aside the HK\$1.9 million and make an application to the Court for directions as to whether any part of the same should be paid to the NSCs.

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² Joint And Several Provisional Liquidators Of Hsin Chong Construction Co Ltd (Provisional Liquidators Appointed) v. the Chinese University Of Hong Kong And Others [2021] HKCA 1581.

Accordingly, the PLs proceeded to make an application under s.200(3) CWUMPO³, requesting directions on whether the PLs should make any distributions to the NSCs out of the HK\$1.9 million received from CUHK as outstanding payment for the NSCs.

The Decision of the Court of First Instance

The CFI declined to entertain the PL's application. In short, the CFI took the view that applications under s.200(3) CWUMPO should be reserved for cases where a genuine difficulty arises in the course of a liquidation and should not be brought lightly. In this case, the CFI considered that the PLs were requesting the Court to seek directions on commercial matters which fall within their discretion with the intention of absolving themselves from the responsibility for making such a decision, which was not the purpose of s.200(3) CWUMPO.

In further indicating its displeasure at the application, the CFI ordered that the costs of the application be borne by the PLs.

The PL's appealed to the Court of Appeal.

The Court of Appeal's Decision

The Court of Appeal (CA) overturned the decision of the CFI and held that, although it agreed with the principle that applications under s.200(3) CWUMPO should not be lightly made, it took the view that the application of the PLs raised genuine legal questions and/or disputed issues, namely:

- Whether a set-off mechanism negates a trust in respect of the retention monies (the Set-off Question);
- Whether the retention monies have been sufficiently segregated such that a trust had been created (the Segregation Question); and
- Whether the non-retention monies form part of the estate of Hsin Chong, or alternatively can be distributed to the NSCs pursuant to the provisions on direct payment (the Direct Payment Question).

Furthermore, the CA noted that the PLs had a duty to seek directions where a difficulty arose during the course of administration and, if the Court took the view that an application was legitimate then some advice or direction should be provided so that the court does not leave the PLs "floundering".

On the Set-off Question, the CA noted that there were apparent inconsistencies in the existing case authorities on the issue of how the provision for holding retention monies on trust in a building contract may be affected by a set-off provision in the same contract. In particular, an earlier judgment of the CFI had indicated that a right of set off related to a third-party indebtedness is contrary to the very existence of a trust.

Upon review of the authorities, the CA reconciled the apparent inconsistencies and concluded that, in circumstances where the contract expressly provides for a right of set off from monies held on trust for a third party, the right of set off and the trust can co-exist side-by-side.

Similarly, on the Segregation Question, the CA noted that there were conflicting authorities on the extent to which monies held on trust had to be segregated and, after a thorough review of such authorities, held that provided the trust monies could be clearly identified, it was not strictly necessary to keep them in a separate fund.

Accordingly, the CA directed that the retention monies owed to the NSCs were to be released to the NSCs.

On the Direct Payment Question, the CA took the view that the non-retention monies received by Hsin Chong from CUHK for the NSCs were part of the estate of Hsin Chong and were to be distributed to the creditors in general. Although this was not a difficult legal question (as there was no issue of whether or not it was held on trust), since one of the NSCs had put forward an alternative view, the PLs were entitled to raise it as part of its application under s.200(3) CWUMPO.

Conclusion

The judgment of the CA provides some much needed judicial guidance on the circumstances in which liquidators can make use of the 200(3) CWUMPO to reconcile conflicting views of creditors. Although the rule remains that such applications should not be lightly made, if there is a genuine issue of law on which there are conflicting authorities, liquidators are entitled to raise it under such an application.

The judgment also clarifies that where expressly provided for in a contract, a set off mechanism and a trust in respect of retention monies can coexist, with the consequence that if a sub-contractor can establish that the retention monies owed to it are held on trust, it has priority to those monies over all the other creditors.

³s.200(3) CWUMPO provides that liquidators may apply to the court "for directions in relation to any particular matter arising under the winding up"

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