

Introduction of a Statutory Corporate Rescue Procedure and Insolvent Trading Provisions

Comments of the Hong Kong Bar Association

I. Preamble

1. The Secretary for Financial Services and the Treasury has invited the Hong Kong Bar Association (“**the HKBA**”) to comment on certain issues in relation to the administration’s proposals (“**the Proposals**”) on the introduction of (1) a new statutory corporate rescue procedure (“**CRP**”) and (2) insolvent trading provisions (“**ITPs**”).
2. In principle, the HKBA supports the introduction of the CRP and the ITPs, which facilitates companies with viable long-term business prospects but are in short term financial difficulty, to turn around or restructure.

II. General View

3. At present, Hong Kong companies with financial difficulties have the following options:
 - 3.1. coming to a non-statutory consensual arrangement with their creditors;
 - 3.2. coming to a compromise or arrangement under Part 13, Division 2 of the Companies Ordinance (Cap.622) (“**CO**”); or
 - 3.3. effecting a corporate restructuring through the moratorium provided by the provisional liquidator regime under sections 192 and 193 of the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32) (“**CWUMPO**”).

4. However, each of these options has its own drawbacks:
 - 4.1. the successful implementation of a non-statutory arrangement depends entirely on the voluntary cooperation on the part of the creditors of the company, and requires the consent of all creditors.
 - 4.2. an arrangement under Part 13, Division 2 of the CO can be disrupted at any time if a creditor decides to petition for the company to be wound up, given the lack of a moratorium.
 - 4.3. under s.193 of the CWUMPO, a provisional liquidator could only be appointed where the company is insolvent and the company's assets are in jeopardy. It is well established that the court will not appoint provisional liquidators merely for the purpose of enabling the company to proceed with restructuring so as to avoid its winding-up (*Re Legend International Resorts Ltd* [2006] 2 HKLRD 192).
5. In the premises, the HKBA considers that it is beneficial to, and in the interests of all companies in Hong Kong, to introduce the CRP. The HKBA is of the view that the Proposals, if introduced, will maximise the chances for survival of a company with solid long term prospects but in temporary financial difficulties. This, in turn, increases the prospect of a better return for the company's stakeholders.

III. Specific Comments

(1) Initiation of CRP where there is no major secured creditor ("MSC")

6. The HKBA notes that, under the Proposals, the written consent of the MSC is required prior to the appointment of a provisional supervisor ("PS") to commence the CRP. There is no such requirement when there is no MSC.

7. The HKBA broadly agrees that there must be some safeguards when a company does not have any MSC.
8. For instance, in England, when there is no holder of a “Qualifying Floating Charge” and when the administrator is appointed by the company or its directors, a creditors’ meeting may replace the administrator so appointed: see Paragraph 97 of Schedule B1 to the Insolvency Act 1986.
9. The English approach thus allows the non-MSC creditors to determine the identity of the administrator.
10. To this end, the HKBA notes that a similar approach has been adopted in the Proposals at Legislative Council Document No. CB(1)1536/13-14(01).
 - 10.1. It has been suggested that, within 10 business days from the commencement of provisional supervision, the PS will be obliged to call a 1st creditors’ meeting for considering whether to maintain or replace the PS appointed by the initiating party and whether to appoint a committee of creditors (and if so, its membership).
 - 10.2. It has also been proposed in Legislative Council Document No. CB(1)1536/13-14(01) that any creditor may apply to the Court to examine the conduct of the PS for misfeasance or breach of duty and, when appropriate, to make orders against the PS (such as ordering payment to compensate the company).
11. In the circumstances, the issue is this: should there be an *additional* power, not subject to any time limit, on the part of the creditors (whether MSC or not), to apply to the court for termination of the provisional supervision (i.e., the “safeguard provision”)?
12. The HKBA has reservations over this proposal.

12.1. **Firstly**, the HKBA notes that the power to apply to the Court for termination of provisional supervision is conferred on each and every creditor. In the circumstances, it may be difficult to prevent vexatious or abusive applications despite the deterrence of an adverse costs order and the Court's powers to strike out or stay unmeritorious and abusive claims. HKBA has concerns that this may give minority creditors with a very minor stake in the provisional supervision a disproportionate "bargaining chip".

12.2. **Secondly**, under the Proposals at Legislative Council Document No. CB(1)1536/13-14(01), creditors, acting by the creditors' meeting, already have rather extensive powers to influence the course of the provisional supervision at different junctures. For example, at the 1st creditors' meeting, they may influence the identity of the administrator, and at a subsequent creditors' meeting held to determine if the provisional supervision should be extended. The power on the part of each and every creditor to apply to the Court to terminate the provisional supervision may be misused by minority creditors to challenge the decisions made in these creditors' meetings.

12.3. **Thirdly**, the HKBA notes that, under the proposal, a creditor may apply to court for termination of the provisional supervision at any time. It is suggested that there must be a specified time limit in order to provide commercial certainty to the company and to the creditors.

13. To conclude, HKBA's view is as follows:

13.1. The "safeguard provision" is essentially a measure to protect minority creditors, to avoid possible "tyranny of the majority" situations. The intent is legitimate and not, of itself, controversial.

13.2. On the other hand, the "safeguard provision", if too liberally granted, has the potential of derailing provisional supervision, at

a time when commercial certainty and confidence is of paramount importance.

13.3. In this regard, HKBA suggests the following:

- (a) A qualification requirement should be added, e.g., creditor(s) holding a debt of no less than 10 per cent. of total liabilities of the company, as stated in the latest available audited accounts of the company or as determined by the PS.
- (b) A temporal limit should be added, e.g., an application should be made no later than 28 days after the 1st creditors' meeting.

(2) Proposed definition of MSC

14. Under the Proposals, MSC is defined to include holders of subsequent charges over the whole or substantially the whole of the company's property. The definition of MSC is as follows:

- 14.1. the holder of a charge, whether fixed or otherwise, over the whole or substantially the whole of the company's property; or
- 14.2. the holder of two or more charges, whether fixed or otherwise, on the company's property where the property subject to those charge constitutes the whole or substantially the whole of the company's property.

15. There are concerns that junior-ranking MSCs with no "real economic interest" may be able to impede the commencement of CRP by withholding their consent to the appointment of PS.

16. In this regard, the HKBA takes the view that, in line with the UK and Australian approach, the rights of MSC-chargees to appoint the PS should not be distinguished on the basis of priority.

17. **First**, distinguishing MSCs on the basis of priority may lead to disputes over priority or validity of charges at an early stage of the CRP, resulting in (1) unnecessary expenses on the part of the company and parties involved; and (2) delay at a time when swift decision making is important.
18. **Secondly**, it appears difficult to assume that a junior ranking MSC-chargee would have a lesser incentive to ensure survival of the company – in fact, in many cases it may have a stronger incentive to ensure the survival of the company and/or maximise the assets available for distribution than a senior ranking MSC-chargee, whose interests are already fully secured.
19. **Thirdly**, the proposed definition of MSC is in line with the definition of “Qualifying Floating Charge” in England: see Paragraph 14 of Schedule B1 to the Insolvency Act 1986. Unless complaints have been identified in the English regime, there is no reason to believe that there is a problem to be fixed *via* some novel approach.

(3) Personal liability of PS

20. In case of a replacement of the PS, there are concerns that the outgoing PS would terminate all contracts for which he is personally liable in order to crystallise his liabilities at the time of leaving his or her office. To address this concern, some stakeholders suggested that the indemnities of liabilities of the outgoing PS should be accorded higher priority over the indemnities of the incoming PS.
21. The HKBA is of the view that the above concern is unlikely to materialise. As a matter of law, the company is not at liberty to unilaterally terminate contracts with third parties save where the contract allows it to do so, at least without incurring liabilities for breach of contract.

22. Given that current plans are for the outgoing PS to owe fiduciary duties to the company,¹ the PS has no unfettered right to terminate such contracts at will without exposing himself to liability.
23. Further, HKBA understands that under current plans, a PS would only be personally liable for claims or damages in respect of a cause of action which arose during his or her office as the PS – as such, there should be no or little incentive for the PS to terminate all contracts adopted by him.
24. Finally, the HKBA notes that the current Proposals allow a PS to be indemnified out of the company's property in his custody for debts he is personally liable; and such indemnity would have priority over all other claims and unsecured creditors.² The HKBA considers that the indemnity offers sufficient protection for PS.

(4) Statutory defence for insolvent trading provisions

25. Under the existing proposals, it would be a statutory defence to insolvent trading if –
 - 25.1. the director has taken all reasonable steps to prevent the company from incurring the debt; or
 - 25.2. the incurring of the debt is part and parcel of the steps taken by the director concerned to initiate the CRP process.
26. To this end, two further proposals are now being suggested by the administration:-
 - 26.1. the scope of the proposed statutory defence is to be extended to cover steps taken by the directors to initiate an "arrangement and compromise" under Part 13 of the CO or an "informal workout" in relation to the company.

¹ Letter from the Secretary for Financial Services and the Treasury dated 10 June 2016, §10.

² Consultation Conclusions on Corporate Insolvency Law Improvement Exercise and Detailed proposals on a new Statutory Corporate Rescue Procedure, 28 May 2014, §18.

- 26.2. an additional "safe harbour" is introduced, to the effect that a director would not be liable if (i) he in good faith believes that the company incurs the debt for the purpose of returning the company to a state of solvency within a reasonable period of time; and (ii) there are reasonable grounds to support his belief.
27. As regards the proposal to extend the proposed statutory defence to cover steps taken by the directors to initiate an "arrangement and compromise" under Part 13 of the CO or an "informal workout" in relation to the company, the HKBA broadly agrees with the spirit of the proposal.
28. The HKBA only wishes to highlight two points.
- 28.1. Firstly, there is a need to define "informal workout" precisely.
- 28.2. Secondly, some arrangements under Part 13 of the CO are bound to fail, e.g. when it is clear that it would be impossible to obtain the 75% statutory majority under Part 13 of the CO. In this case, in principle, steps taken by the directors after they realise or should have realised that the arrangement is bound to fail should not be exempted.
29. As regards the proposed "safe harbour", the starting point is that the proposed insolvent trading provision is materially different from the English wrongful trading provision (s.214 of the Insolvency Act 1986), in that the proposed insolvent trading provision applies when a director knew or ought to have known that the company was insolvent at that time or would become insolvent by incurring the debt, while the English wrongful trading provision applies only when a director knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation.
30. The proposed insolvent trading provision appears to be stricter, in that a director is liable as long as he knew or should have known that the

company was insolvent, even though there might be a reasonable chance for the company to avoid insolvent liquidation.

31. Accordingly, there may well be a need to introduce the proposed “safe harbour” to protect a director who is trying to “turn around” an insolvent company which has a reasonable chance of avoiding insolvent liquidation.
32. As to the subjective and objective knowledge test, the HKBA notes that the suggested approach is broadly consistent with the English s.214 of Insolvency Act 1986.

(5) Other technical issues of CRP

33. As to the mandatory set-off issue, the operation of s.264 of the CWUMPO can be illustrated by the decision of Harris J in *Re Tsz Wan Shan Ltd* [2010] 4 HKLRD 291.
34. The HKBA notes that the proposed approach is consistent with the existing legal principles on mandatory set-off.
35. As to the commencement date of a winding-up which has been interrupted or preceded by provisional supervision, the HKBA notes that an earlier commencement date would imply a longer avoidance period.
36. The proposed approach is broadly in line with the English approach. To this end, s.240(3)(d) of the Insolvency Act 1986 provides that:-

“For the purposes of subsection (1), the onset of insolvency is—

...

(d) in a case where section 238 or 239 applies by reason of a company going into liquidation either following conversion of administration into winding up by virtue of Article 37 of the EC Regulation or at the time when the appointment of an administrator ceases to have effect, the date on which the company entered administration (or, if relevant, the date on

which the application for the administration order was made or a copy of the notice of intention to appoint was filed) ”

37. The HKBA also notes that the proposed approach is broadly consistent with s.387(3)(a), (aa) and (ba) of the Insolvency Act 1986 (relevant date for the purpose of determining preferential debts).

IV. Conclusion

38. As the Courts in Hong Kong have repeatedly observed, the introduction of the CRP is long overdue. It is to be hoped that the CRP proposals would be implemented as soon as practicable.

Hong Kong Bar Association

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