To: Division 4, Financial Services Branch, Financial Services and Treasury Bureau, Hong Kong.

RE: Consultation Paper on the Review of Corporate Rescue Procedure Legislative Proposals

Date of submission: 30th December 2009.

Part A: General Information of the Respondent

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Part B: Detailed Questions for Response

Question 15

Do you support the introduction of insolvent trading provisions? In case you do not, please explain and suggest alternatives to (a) encourage timely initiation of provisional supervision; and (b) deter irresponsible depletion of the company's assets.

Overall, we support the HKSAR government policy initiatives and objectives laid out in the *Companies Ordinance (Corporate Rescue) Bill* (CCR Bill) amidst the recent global financial crisis. We believed that the enactment of the CCR Bill will be beneficial to Hong Kong's economy and reputation as a financial hub in the Asia-Pacific region. The reason is simple, without robust insolvent trading laws, directors are more likely to engage highly risky or make reckless decisions out of desperation which would cause harm to the company and the company's creditors. This could also have a domino effect on other companies by causing financial distress as experienced in the Asian financial crisis over a decade ago.

In addition, the introduction of insolvent trading provisions holding directors personally liable for losses suffered by the company and creditors will enhance Hong Kong's corporate governance standards and accountability of directors to match other common law jurisdictions like Australia.[1]

This legal obligation could also have a positive effect on the quality of Hong Kong's directorship. By heightening the standard of care in line with the recommendations in the Draft Companies Bill – first phase consultation published in December 2009. Higher standards of care can and will instil greater confidence amongst shareholders and creditors because no company can afford to have directors acting negligently, as per Bokhary J in *Chingtung Fixtures Ltd (in Liquidation) v Arthur Lai Cheuk Kwan and Others*[2].

[1] The Review of Corporate Rescue Procedure Legislative Proposals compared Hong Kong's insolvent trading regime with UK and Australian jurisdictions at 6.4.

[2] *Chingtung Fixtures Ltd (in Liquidation) v Arthur Lai Cheuk Kwan and Others* HCA005081/1989.

The higher standard would also mean directors could not claim that they were not familiar with the financial affairs of the company. It was held in *The Official Receiver v Ng Ting Ming*[3] that the respondent was an unfit director because he was, *"[u]nable to handle corporate affairs in any responsible or law-abiding manner"*.[4] The Court contended that, *"[i]t is very important to bear in mind that as the director of a company he has a very important duty to strictly comply with the accounting duties imposed on him. It is because without sufficient accounting records, any directors cannot act responsibly in making decisions whether to continue trading In my view, it is likely that it is as a result of the respondent's failure to keep proper accounts that led to the commission of the other misconduct such as insolvent trading."*[5]

These were some of the reasons why the Australian Federal government introduced a duty for directors to avoid insolvent trading under section 588G of the Australian Corporations Act 2001 (Cth). This provision was based on the recommendations of the General Insolvency Inquiry (Harmer Report 1988), which pointed out the needs for an insolvent trading provision includes the protection of company's interest and to provide adequate remedies to creditors.[6] The Harmer Report outlined the deficiencies of director's duties where the civil remedies sought by creditors were dependent upon prior conviction of the offence and its lengthy procedures. [7] Thus, to protect the companies' and creditors' interests, and speedy debt recovery, we contend that it is crucial for Hong Kong to have a similar provision in imposing a 'positive duty' for directors to prevent insolvent trading as opposed to focusing on each particular debt with individual complex examinations for creditor's recovery. [8]

Question 16

Do you agree with the proposed revised formulation of "insolvent trading"? If not, please suggest alternatives.

We disagree with the proposed revised formulation of "insolvent trading".

In particular, we are opposed to the proposed removal of (1) (b) because it would seriously weaken to operability of (2) to act as a preventive mechanism.

According to an Australian case "suspect" means, *"[m]ore than a mere idle wondering whether [insolvency] exists or not, it is a positive feeling of actual apprehension or mistrust, amounting to a slight opinion, but without sufficient evidence"*.[9] Also in *Metropolitan Fire*

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[3] *The Official Receiver v Ng Ting Ming* HCMP 2441/2007.

[4] Ibid at 32.

[5] Ibid at 28.

[6] The Law Reform Commission. (1988) *General Insolvency Inquiry (Harmer Report).* 45 Vol 1. Canberra. Australian Government Publishing Service at 280- 286.

[7] Ibid at 279.

[8] Ibid at 280.

[9] *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303 per Kitto J.

Systems Pty Ltd v Miller, Einfled J held that reasonable grounds to suspect, *"[m]ust be judged by the standard appropriate to a director of ordinary competence."*[10]

This denotes any prudent director must investigate further into the likelihood of insolvency, if he or she believed that there were sufficient grounds to do so. Thus concerns by Hong Kong's business sector that (1)(b) would discourage directors from taking any risk might be overstated and unfounded.

As held in the case of *Re: Goldcone Properties*, the directors have been taking significant risks to enter in purchase of a RMB 43 million liability and loans to its directors totalling HKD 36.5 million even when the company is in apparent deficiency of current assets against current liabilities and resulted in liquidation of the company. [11] Therefore, the inclusion of (1)(b) would encourage better risk management.

Furthermore, in 6.4 of the Review, the FSTB held the view that insolvent trading provisions are implemented to encourage directors to act on insolvency earlier rather than later to prevent further erosion of the distressed company's assets at the detriment of creditors. But without (1)(b), how or when would a director is expected to take reasonable steps to prevent insolvency. If the aim of (2) is for directors to act when he or she knows the company in a serious financial distress, this might be too late, since having systems in place to prevent insolvency is to inform a director there is cause for concern, and this is prompted when a directors have doubts about the company's financial viability, not when he or she is certain.

Without this heightened alert in (1)(b), we contend that it is unfair to demand directors to act when he or she knows the company is in financial difficulty and hold them personally liable for the dents incurred. By acting earlier - that is, as soon as any suspicion occurs, it can prompt directors in immediate action. We hold the view that the sooner they act, the more they can resolve in the light of corporate rescue.

We also agree with Professor Smart's submission in 2001, [12] that the word "any" in subsection (2) should be replaced by "all", hence construed as:

*"the responsible persons failed to take **all** steps to prevent the insolvent trading".*

We contend that in order for the director to rely on this defence, he or she must have demonstrated sufficient effort in protecting the company's interests in prevention of insolvent trading. Individual steps of prevention ought to be exercised in every possible way and be examined in light of the entire financial situation of the company.

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[10] *Metropolitan Fire Systems v Miller* (1997) 23 ACSR 699 at 703 per Einfeld J.

[11] *Re: Goldcone Properties Ltd* [1999] HKCFI 980; HCCW000391/1999, 4 November 1999.

[12] Smart, P, (2001) *Submission Paper in response to Companies Ordinance Corporate Rescue Bill 2001.*

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