Grant Thornton
均富

Grant Thornton
6th Floor, Nexxus Building
41 Connaught Road Central
Hong Kong

T +852 2218 3000
F +852 3748 2000

均富會計師行
香港中環
干諾道中 41 號
盈置大廈 6 樓

電話 +852 2218 3000
傳真 +852 3748 2000

www.gthk.com.hk

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By Fax (852) 2869 4195 and By post

Division 4, Financial Services Branch
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong

23 February 2010

Dear Sirs

Review of Corporate Rescue Procedure Legislative Proposals
- Consultation Paper issued in October 2009 ("Consultation Paper")

In response to the Consultation Paper, we have set out our comments on the 19 questions raised therein. We have also added a brief paragraph on the need to consider Hong Kong – Mainland China cross-border issues.

Should you have any questions regarding the above, please do not hesitate to contact me on or Mr Terry Kan on

We apologise for the delay in our submission.

Yours faithfully

Alan CW Tang
Partner

Encl.

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Grant Thornton – Submissions and comments on the "Review of Corporate Rescue Procedure Legislative Proposals - Consultation Paper" issued in October 2009 ("Consultation Paper")

1. ***Do you agree with the proposed procedural changes relating to initiation of provisional supervision in paragraphs 2.4 to 2.6 above? If not, please provide reasons and suggest alternatives.***

   We generally agree to the proposed procedural changes with regard to the initiation of provisional supervision ("**PS**") with the following suggested refinement for consideration:

   In addition to the filing of the notice of appointment and other required documents with the Companies Registry, the Official Receiver should also be notified as there may be other insolvency proceedings in progress already involving the Official Receiver's Office ("**ORO**") in one way or the other.

2. ***Do you see any need for other changes to the initiation of provisional supervision, including who may initiate the procedure? If so, please elaborate on the suggested changes and reasons.***

   The 2001 Bill does not provide for any creditors including secured creditors or shareholders to initiate the PS. Whilst we agree to the "consideration" as noted in para. 2.3 of the Consultation Paper, we observe from experience that there will be situations (e.g. shareholders' dispute, management deadlock, absconded directors etc.) where it is necessary for creditors (secured or otherwise) or shareholders (as opposed to the company (acting through its directors) or the directors (acting through the Board of Directors)) to initiate the PS process.

   The law should be flexible to allow for such possibilities, which would be regarded as exceptions, and which would need to be sanctioned by the Court on terms and conditions to be specified by the Court.

3. ***Do you agree that the notice of appointment of provisional supervisor should be published in the local newspapers on the same day as the date on which the last document is filed with the Registrar of Companies? If you prefer additional or alternative means of publishing the notice of appointment, please describe and explain.***

   We agree with the proposed advertisement of the notice of appointment of provisional supervisor in order to enable creditors to be informed as soon as practicable, noting that the first meeting of creditors should be held within 10 days from the commencement of PS.

   Insofar as overseas creditors and stakeholders are concerned, it is in principle up to them to arrange at their own costs a mechanism of "monitoring" their debtors / investment in Hong Kong. In cases where there are substantial numbers of overseas creditors / stakeholders, any experienced provisional supervisor will likely arrange for their appointment to be advertised in newspapers with an international circulation.

In theory, overseas stakeholders may access and search from the web-site of the Registrar of Companies to note the commencement of PS. However, it is important that the Registrar of Companies place such up-to-date filing of commencement of PS on its web-based search systems in time.

There is a requirement that the notice of appointment of provisional supervisor set out, among other things, "the rate proposed to be paid to the provisional supervisor by way of remuneration ". It would be useful if this reference to "rate" be clarified / specified as remuneration tends to be a sensitive issue and undue attention should NOT be drawn to this at commencement of the PS.

4. ***Do you support an initial moratorium period of 45 days? If not, please suggest alternatives and explain.***

We support the extension of the initial moratorium period from 30 days to 45 days.

5. ***Do you support the proposal to allow for extension of the moratorium up to a maximum period of six months from the commencement of provisional supervision, subject to approval by the creditors at a meeting of creditors? If not, please explain and suggest alternatives.***

We support the proposal. However, it should be specified how "approval" by the general body of creditors at a meeting of creditors is to be obtained (i.e. by simple majority or otherwise). It should also be specified how the "claims" of creditors are determined for voting purposes

Besides, there should be provisions for the provisional supervisor to apply direct to the Court to seek such an extension in the event of disputes amongst creditors over the identity of and/or quantum of claims from certain creditors (e.g. parties alleged to be related-parties to the shareholders/directors, as we have seen at some hostile creditors' meetings), which disputes would often need to involve the Court anyway.

6. ***Do you agree with the proposal to allow for extension of the moratorium beyond six months only upon court approval? If not, please explain.***

Yes, in principle.

7. ***If your answer to Q6 is yes, do you agree that any court extension should not exceed a maximum of 12 months from the commencement of provisional supervision? If not, please explain and suggest alternatives.***

Yes, we also agree in principle that any Court extension should not exceed a maximum of 12 months from the commencement of PS, UNLESS in exceptional circumstances to be made out by the provisional supervisor and to be determined by the Court on a case-by-case basis. We believe that the Hong Kong Court has been very experienced in dealing with similar applications since the Asian Financial Crisis in 1997/8.

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Many "restructurings" since 1997/8 involving listed companies via provisional liquidators have taken more than 12 months to be finalised and ultimately approved by the Court. This is particularly relevant where more and more of these situations will inevitably involve major operations in the PRC.

8. ***Does the list of contracts and agreements which should be exempted from the moratorium, as set out at Appendix, need to be revised? If so, please suggest and explain.***

We consider that in principle specific financial contracts and agreements should be exempt from the moratorium due to their nature and / or operation. However, given the ever-changing nature of such financial products and rather than setting "in stone" such a list in the legislation, provisions should be incorporated to the effect that such a list is to be determined and specified by the relevant Government regulatory bodies, e.g. the Hong Kong Monetary Authority etc. by subsidiary legislation or otherwise.

9. ***Which of the above three options (namely, the 2003 Proposal, Alternative A or Alternative B) would you prefer? Please explain. If you have any suggestion to refine any of the above three options, please describe and explain. If you prefer another alternative, please describe and explain.***

Of the three options, Alternative A will create the most uncertainty for all concerned and will no doubt divert much valuable time and resources of the provisional supervisor to deal with disgruntled former and current employees, who will NOT agree to work with the provisional supervisor unless and until their terms and conditions are met / agreed / compromised.

The "PWIF mirror" in the 2003 Proposal was, we believe, first promulgated by one of our partners at the time during the 2000/2001 consultation and during the then Legco Working Committee/Group meetings. However, it was then already apparent that the source of new funding to cover such immediate cash commitment to employees would be a major concern / impediment.

Thus, on balance, we would prefer Alternative B, with minor modifications. One modification is to distinguish the liabilities owing to former employees from those owing to current employees. The "Employees' Protected Debts" should cover only those of current employees whereas the liabilities of former employees would be dealt with as part of the voluntary arrangement. The rationale is simple: only current employees' contributions are required in the PS and it is just right that their positions are fully secured before they commence work under the PS. Note that the position of former employees is not made worse off.

Another modification is the granting of the right of subrogation to the "white knight" or funder in respect of funding to cover the "Employees' Protected Debts", in the event that PS fails and the subject company goes into liquidation., so that such funding to the PWIF limits are recoverable from the PWIF. This will give the "white knight" the comfort of "security" in respect of the new funding required to pay the current employees in order to kick start the PS process, in the event the efforts for a PS fail.

We also have the following general comments on employees' claims.

Practical and operational issues and considerations

Discussions over the years on the position of arrears of wages and other employees' entitlements ("**Labour Claims**") in PS centre on the following key issues:-

- Whether employees (former and/or current) should be paid their entitlements in full[1] vis-a-vis general creditors who are expected to "take a loss";
- Timing of payment of Labour Claims;
- Source of funding to pay Labour Claims;
- Ultimate responsibility to pay/fund Labour Claims (PWIF?) in case voluntary arrangement fails; and
- Personal exposure and liability of Provisional Supervisor / Administrator in respect of Labour Claims.

As to whether payment in full or otherwise of Labour Claims and timing of such payment, it may be "fair" to take a practical view and approach. For any rescue and voluntary arrangement to succeed, besides new funding and new business opportunities etc., the input and full support of management and employees are essential. It would be practically impossible for any Provisional Supervisor / Administrator to operate the business with no employees or no support from employees. Thus, it is important that all outstanding entitlements of all current employees be either paid or provided for in full. Former employees no longer contribute to the rescue operations; their entitlements may be dealt with as part of the voluntary arrangement (with full payment of at least their PWIF entitlements).

With regard to funding of the Labour Claims, if the company is successfully rescued, no doubt the funding will come from itself (through the "white knight" or otherwise). However, in the event that the rescue attempt fails and the company is wound up (by way of court liquidation or otherwise) within a specified period (say 12 months) after commencement of the voluntary arrangement, the PWIF-equivalent payments to the employees (if made) should not be ultimately borne by the "white knight" or the "new funding" of the company. Rights of subrogation should be afforded to such funder to mount claims against the PWIF in respect of payments made to employees.

There should be no personal exposure or liability to the provisional supervisor in respect of Labour Claims which have arisen from employment contracts NOT entered into by him. Any attachment of personal liability of the provisional supervisor to pay employees will likely result in almost instant dismissal on Day One of all employees of the company to be rescued, followed by protracted negotiations to re-engage selected employees (but then creating factions as well as friction); hence defeating the very purpose of a rescue attempt.

One important operational issue now facing potential corporate rescue attempts in Hong Kong is the substantial operations of most manufacturing businesses in Mainland China, often through locally established joint-ventures or WFOEs. Workers of the key manufacturing units of a "Group of Companies" in Mainland China are actually subject

[1] Some form of preference is already accepted as reflected in current legislation.

to a different set of labour laws in a different jurisdiction. Often, their agreement to and support of any rescue attempt is crucial. How their entitlements and claims are to be dealt with is now not envisaged in the current proposals (because they are not within the jurisdiction); but experience shows these would need to be seriously considered in any rescue attempts. Any new corporate rescue legislation should be flexible enough to allow the provisional supervisor and/or stakeholders to deal with cross-border issues (including employee-related issues) in Mainland China.

10. Independent of which of the above options is adopted, what are your views on the treatment of outstanding employers' MPF scheme contributions?

In general, outstanding employers' MPF scheme contributions should be treated in the same way as employees' arrears of wages and other entitlements under the EO. However, detailed provisions may need to be worked out to deal with the "circular" calculations affecting employees' entitlements to severance payments in respect of such employers' contributions.

11. Do you agree with the proposal that solicitors holding a practising certificate issued under the Legal Practitioners Ordinance (Cap 159) and certified public accountants registered in accordance with the Professional Accountants Ordinance (Cap 50) may take up appointment as provisional supervisors?

We agree that certified public accountants registered in accordance with the Professional Accountants Ordinance (Cap 50) **but only** with relevant post qualification experience in restructuring and insolvency-related matters are eligible to be nominated to act as provisional supervisors. Likewise, solicitors holding a practising certificate issued under the Legal Practitioners Ordinance (Cap 159**) but only** with relevant post qualification experience in restructuring and insolvency-related matters may also undertake such work provided that they also satisfy the post-qualification experience currently adopted by the ORO in respect of the "Panel A" Scheme.

For practical reasons, small to medium sized companies are unlikely to invoke the process of PS. For usually high-profile corporate rescue cases which involve going concern businesses in multiple jurisdictions (i.e. Hong Kong, Mainland China and elsewhere), this role of a provisional supervisor is expected to be similar to that of a provisional liquidator which is usually taken up by qualified accountants who have the technical expertise and experience, and can mobilise substantial resources upon short notice.

We are of the view that adopting the current Panel A Scheme (which itself is being reviewed) as a qualifications criteria should be considered, noting that creditors may elect a different provisional supervisor at the first meeting of creditors in 10 days after the commencement of PS. In practice, we believe that the appointment of a provisional supervisor would, in most cases, have been endorsed by the major creditors group before the commencement of PS, in order to save costs and time for election of a replacement during this time critical process. If not, such appointment could be replaced at the first meeting of creditors.

12. ***Do you think that other persons without the above qualifications could also be appointed as provisional supervisors on a case-by-case basis? If so, should such an appointment be made by the OR or the court? Please elaborate, in particular on the appeal channel in case of aggrieved applicants and on the associated investigatory and disciplinary regime in case of complaints against appointed persons.***

No. Similar to the current provisions of the Companies Ordinance for the appointment of provisional liquidators under s. 228A, provisional supervisors should have the above (see 11) qualifications and relevant experience. This will prevent the appointment of unqualified and undisclosed connected persons by major shareholders / directors to "officially" siphon off assets, particularly those outside of the jurisdiction (e.g. in Mainland China).

13. ***Do you agree with giving creditors the choice to replace the provisional supervisor appointed by the company or its directors or the provisional liquidators or liquidators of the company and approve the remuneration of the provisional supervisor at the first meeting of creditors to be held within 10 working days from the commencement of provisional supervision? If not, please elaborate on the reasons and suggest alternatives.***

Yes.

14. ***Do you support imposing personal liability on provisional supervisors as proposed in paragraphs 5.14 to 5.17 above? If not, please suggest alternatives which would effectively address the issues set out under paragraphs 5.16(a) to (c).***

We believe that professional insolvency practitioners would (and should) carry out their assignments with due care and diligence, and properly discharge their required duties as reasonably expected from creditors and stakeholders both before and during their engagement period. This must be the basis of appointing any one to be a provisional supervisor.

Attachment of personal liability in any respect is certainly not welcomed by most, if not all, insolvency practitioners. While a limited liability company always operates without **express** personal liability attachments of its directors, why would the appointment of a provisional supervisor fundamentally change the basis of its operation? To the extent like a delinquent director, a reckless, negligent and grossly unfit provisional supervisor will have incurred personal liabilities in respect of his wrong-doings regardless, whether with any express personal liability attachment or otherwise.

From a practical point of view, and if with any personal liability attachment, the provisional supervisor will seek professional indemnity insurance cover in the market to cover the risks of taking up the role as a provisional supervisor. However, for commercial reasons, it has already been difficult and costly over the last few years to obtain the right insurance cover for the appointment even as provisional liquidators / liquidators. We believe that this will be even worse in seeking PI cover for provisional supervisors. Costs of any such cover are likely to be high.

The confidence of suppliers and creditors to continue trading with any financially-troubled company, in our view, depends on the long term viable future of the company as well as short term cash flow arrangements (e.g. COD basis). It also depends on the confidence that may be provided by the new investors both in terms of their financial capability and their determination to rescue the distressed company. We do not see how any personal guarantee to be provided by the provisional supervisor will enhance the confidence of creditors in this regard. For large-scale restructuring cases involving total contracted sums involving hundreds of millions of dollars, any attempt to terminate all contracts by the provisional supervisor in the first place and to be replaced by newly-negotiated contracts where necessary will simply not work. As a practical alternative, perhaps the onus should be on the suppliers and creditors to seek to determine their contracts with the company within the 16-day "cool-down" period if they so wish; otherwise, there would be no change to the status quo of the normal trading terms and conditions.

For those not suitably qualified or undisclosed connected persons who may be appointed initially as provisional supervisor, we believe that the current process of convening the first meeting of creditors in 10 days after commencement of the PS would be an adequate mechanism to enable creditors to consider replacement of any provisional supervisors. As an extra "safeguard", we suggest that during the process of the PS, any aggrieved creditors, with an aggregate 10% or more in value of the total known claims, may at its own costs unless otherwise agreed to by the general body of creditors, call for a meeting of creditors at any time between the statutory first and second meetings of creditors to consider / determine the replacement of the incumbent provisional supervisor.

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.***

Yes.

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

Yes, except that some suitable form of reference to "senior management" should be retained, as "shadow director" per se may not be wide enough to "catch" people who ought reasonably to have known the company was insolvent. A typical example would be the Financial Controller of a company/group, who is not also a director. He/she would be one of the best persons to know / realise the insolvency of a company; but without any statutory requirement / backing, he/she is often prevented (either voluntarily or involuntarily) from "acting" to deal with the insolvency.

There should be express provision that "senior management" will exclude professional advisors engaged by the company or any individual director during the PS process, including the provisional supervisor as well as those lenders who usually are also likely to be actively involved throughout the restructuring process.

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17. Do you agree with the way that "major secured creditors" was defined in the 2001 Bill? If you think any changes are needed, please elaborate and explain.

We agree to the current proposed definition as it appears to be in line with the wordings used under s. 300A of the CO in relation to receivers' appointments. For example, in the case of a "group" of companies where all patents, trademark and knowhow for its operations are held by one company, any secured creditor with security over that company's assets and/or shares in that company will no doubt be "major", although in terms of "value", it may not be significant on the balance sheet of the "group".

18. Do you support the proposal to largely follow the 2001 Bill approach with respect to protection of "major secured creditors" and other secured creditors' rights? If you think any changes are needed, please elaborate and explain.

Yes. However, provisions should be made to deal with situations where there would arguably be more than one "major secured creditor", as well as a multitude of non-major secured creditors.

In a typical restructuring, it is likely that the troubled company would have more than one lender. As an example, one may have a fixed charge over the land and factory premises, the other a fixed charge over the plant and machinery, and yet another a floating charge over all other assets (principally stock, WIP and debtors). The currently proposed approach is that if one of the major secured creditors objects to the PS, then the PS would cease. We consider that this is not satisfactory as one major secured creditor may not represent the "majority view" of other "major secured creditors". Hence, we suggest that, in these situations (and likewise with a multitude of non-major secured creditors), only if the majority in number of the "major secured creditors" (when more than one) are not in support of the PS, then it shall cease.

19. What are your views on retaining or removing the "headcount test" in the voting at meetings of creditors (i.e. requirement (a) stated in paragraphs 8.1 and 8.2 above) for resolutions to be passed at meetings of creditors?

We believe the "headcount test" should be retained. In our experience, the "headcount test", under normal circumstances, has proven to be an important mechanism to enable the voices of employees and small trade creditors to be heard under a scheme of arrangement pursuant to S.166 of the CO.

We are, however, more concerned about the definition and position of "connected persons". Apparently, the current "definition" of "connected persons" is by reference to the meaning of "associate" in the Bankruptcy Ordinance, which does not apply in general to a corporate context. For example, fellow subsidiary or associated companies within a group, or companies with common ownership, do not appear to fall within the definition of "associate" under the Bankruptcy Ordinance If so, this would defeat the very purpose of the 3rd "condition".

We suggest to adopt the definition of "associate" in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.

20. Cross-border considerations

We understand that Hong Kong legislation may not include detailed provisions on how to deal with cross-border situations. Yet, it has become a fact of life that more and more restructuring cases will involve some, if not most, of the operations in Mainland China. The Corporate Rescue legislation should be drafted in general with such a "working model" as the background and provide as much **flexibility** to the provisional supervisor and all other stakeholders to deal with employees, trade creditors, suppliers and other operating issues in Mainland China.