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8 February 2010

By e-mail: corporate_rescue@fstb.gov.hk and registered post

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

Dear Sirs,

Consultation Paper on Review of Corporate Rescue Procedure Legislative Proposals

We refer to the Consultation Paper on Review of Corporate Rescue Procedure Legislative Proposals published by the Financial Services and the Treasury Bureau ("**FSTB**") in October 2009 ("**2009 Consultation Paper**").

On behalf of our members, we set out our observations and views on various proposals in the 2009 Consultation Paper. They build on the submissions previously made by us, commencing with our submission on 14 April 2000 with respect to the Companies (Amendment) Bill 2000 (the "**2000 Bill**"), which was superseded by the 2001 draft Companies (Corporate Rescue) Bill (the "**2001 Bill**").

We understand that after the current public consultation, the FSTB will conduct limited consultation with certain stakeholder groups. We would welcome the opportunity to elaborate on our recommendations and concerns in the limited consultation.

1. General

1.1 At the outset, we applaud any initiative to save viable businesses and promote a corporate rescue culture. However, we consider it to be important that the drafting of the new legislation will be such that the risk of particular debtors abusing it is minimised. We also wish to highlight the fact that HKAB has previously identified a number of critical issues that must be addressed in order to make the process of corporate rescue workable. We take note, however, that many of these issues have not been dealt with in the 2009 Consultation Paper.

1.2 Our understanding is that the Government intends to proceed with the actual drafting of the new bill for introduction to the Legislative Council without

further public consultation. Therefore, we consider it will assist the FSTB if we reiterate below our principal concerns, which in our view, do warrant further consideration and should be taken into account in the corporate rescue legislation, before turning to the 19 questions posed in the 2009 Consultation Paper set out in section 2 of this submission.

1.3 Rights of major secured creditors

1.3.1 The foremost concern of the HKAB is that rights traditionally enjoyed by secured creditors should not be affected by the proposed new legislation. These rights are provided for in statutes and innumerable contracts currently in prevalent use in the market. They are long-standing and well-understood by the business community. Certainty with respect to these rights is a major reason why Hong Kong's banking industry has been so successful, and has contributed to Hong Kong's rise as a financial centre. We therefore submit that a corporate rescue regime which respects and upholds existing rights of secured creditors will promote market stability and confidence.

1.3.2 It follows from the preceding sub-paragraph that the rights of creditors holding security over all or substantially all of the company's assets should not be compromised in any way. They should not be bound into any moratorium unless they give actual consent. The proposed time (3 working days) in which such a creditor is afforded a "window" in which to act is very short bearing in mind the internal decision making processes within creditor organisations. This is one reason behind the recommendation stated in our response below to question 3 in the 2009 Consultation Paper that creditors (especially secured creditors) should be informed forthwith, preferably no later than "day 1", of the commencement of provisional supervision.

1.3.3 Under the current proposal, a creditor who is not a major secured creditor will be bound into a moratorium. We do not consider that any creditor whose claim is partially or fully secured by fixed security should be bound by a moratorium (to the extent the creditor's claim is secured by fixed security) without its consent. We can envisage the situation where a debtor company can easily frustrate legitimate enforcement actions (for example, where a mortgagee has advertised for a long time a tender sale of a property charged by the company) by initiating provisional supervision at the last minute. This should be prevented.

1.3.4 Other legal rights enjoyed by creditors against parties other than the company should not be compromised in any manner by the proposed legislation. We have recently seen in the Australian case of *In the matter of Opes Prime Stockbroking Limited* [2009] FCA 813, the use of a scheme of arrangement to bar creditor's claims against third parties, notably guarantors of the company's debt. It should be made abundantly

clear that (a) any voluntary arrangement cannot purport to affect rights that creditors may have against third parties, and (b) a creditor should be allowed to apply any and all proceeds from enforcement actions against third parties solely and exclusively in the reduction of the debt owing to the creditor.

1.4 Security other than a fixed charge

Security held by a creditor not in the form of a fixed charge will be subject to priority claims by employees and the Provisional Supervisor on account of their fees and expenses. As highlighted in HKAB's letter of 12 November 2001 to the Honourable Margaret Ng, lenders often take other types of security (or obtain rights of security by operation of law). The HKAB identified two types of security that commonly arise in banking practice, namely pledges and liens. It is of fundamental concern that such forms of security (and there are others, such as trust receipts, assigned receivables and factoring arrangements) are not subject to any priority claims.

1.5 Clause 13(4) in the 2001 Bill

It is imperative, in our view, that a creditor holding security should be exempted from the moratorium if the asset subject to the security interest is in jeopardy. The current test of "*significant financial hardship*" under clause 13(4) of the 2001 Bill to exempt the asset from the moratorium is insufficient, in our view, to cover the situation of an asset with currently or imminently diminishing value, or with fluctuating market value.

1.6 Exemption from the moratorium

We identify in our answers to the questions (at question 8) certain transactions that should be exempt from the moratorium provisions. The draftsperson should expressly preserve other creditors' rights that arise out of well established practice. Such rights include the right of combination of accounts, set off, the right to retain control over documents of title and the like.

1.7 Power of a provisional supervisor to dispose of property of the company

It appears that a provisional supervisor may be given power to dispose of any property of the company if there are reasonable grounds for believing the disposal will benefit the company or the disposal is in the ordinary course of the company's business. This would appear to give the provisional supervisor power to dispose of charged property, property the subject of reservation of title claims (and the like) without the consent from the beneficial owner. The HKAB is unable to support such proposal.

1.8 Experience in other jurisdictions

1.8.1 Paragraph 1.6 of the 2009 Consultation Paper states:

> *"[t]he LRC had considered whether a regime similar to Chapter 11 of the US Bankruptcy Code could be adopted in Hong Kong, but concluded that they did* ***not*** *believe that the concept of 'debtor in possession' would be acceptable to creditors in Hong Kong. There were concerns that if the existing management was allowed to remain in control, a company could easily avoid or delay its obligations to creditors. The LRC, therefore, recommended the appointment of an independent professional third party, the provisional supervisor, to take effective control of the company during the provisional supervision period and to formulate a voluntary arrangement proposal for creditors within a specified timeframe."* (emphasis in original)

1.8.2 Paragraph 1.9 of the 2009 Consultation Paper states:

> *"It would not be desirable for us to reinvent the wheel and explore other fundamentally different approaches, such as that of Chapter 11 of the US Bankruptcy Code, because this will deviate from the consensus already reached during the earlier legislative attempts and unduly delay the introduction of a corporate rescue procedure in Hong Kong. Neither has there been a significant change of background circumstances that warrants us to re-explore fundamentally different approaches."*

1.8.3 Paragraph 1.12 of the 2009 Consultation Paper further states:

> *"We expect that provisional supervision would improve the chances of more rescues being attempted and would encourage directors to seek help on a more timely basis.* ***Nevertheless, SMEs may be relatively less likely to benefit from such a procedure due to factors such as the costs involved in engaging an independent professional, limited debt restructuring options, and difficulties in restructuring certain core business activities, etc.***" (emphasis not in original)

1.8.4 It would have been helpful if the Government had conducted a review of the variety of insolvency legislative reforms in Asia in the aftermath of the 1997 financial crisis to see if any developments in the region might be of interest for adaptation in Hong Kong. One of the lessons to be learned from a review of this data is that in most Asian jurisdictions which have enacted corporate rescue mechanisms over the last decade, with a few limited exceptions (for example Japan), there has not been a dramatic take-up rate in the use of these procedures. Hong Kong would most likely prefer to avoid this result and enact a procedure that will prove useful with respect to both large corporations and SMEs.

1.8.5 It would be helpful for the Government to reconsider the applicability of a debtor in possession approach. Clearly, the US version of Chapter 11 would not be a realistic solution for Hong Kong. However, developments in other jurisdictions demonstrate that it is no longer a matter of choosing between a pure debtor in possession approach or the appointment of a provisional supervisor[1]. It is possible to combine the approaches and come up with a hybrid approach, in which a provisional supervisor is always appointed, who is entitled, in his / her discretion, but subject to obtaining the *prior consent of independent creditors*, to carve out *specific and pre-defined management tasks* to the directors, with the provisional supervisor always having *full responsibility, accountability and liability* in respect of the conduct of the provisional supervision. The Government might want to review the recent enactment of the Enterprise Bankruptcy Law (EBL) in the PRC, which has adopted such a hybrid approach (we suggest this with the observation that it appears the EBL does not provide clear guidance on resolving situations where the debtor would like to carry on in possession but the creditors object.)

1.8.6 Allowing an adapted form of a debtor in possession approach would be useful for SMEs in general and especially for closely-held, family run SMEs. There are two significant reasons why a modified debtor in possession approach would be of benefit to SMEs: Firstly, in a family run company there is a great disincentive for a second- or third-generation manager to file for provisional supervision if it will immediately lead to the family member being removed from the running of the business; and second, in many closely-held companies it will be difficult for any restructuring proposal to ultimately prove effective without the support of management, because management's personal connections and relationships will be crucial to the long-term success of the company. Hong Kong is perhaps unique within Asia in that these same arguments might also be applicable to many large, publicly traded companies as well.

1.8.7 To conclude this paragraph 1.8, we anticipate that our proposed "*adapted debtor in possession*" approach will promote a rescue culture, especially in the context of Hong Kong. The major issue under this approach is the degree to which the provisional supervisor should have control over the conduct of the debtor's management and the rescue process. In our view, this issue can be addressed.

[1] As regards the professional qualification of provisional supervisors, please refer to our response to Question 11 set out below.

1.9 Avoidance powers

1.9.1 Under the 2001 Bill, paragraph 2 in Part 1 of Schedule 4 imposes the duty on the provisional supervisor only to "*Investigate and assess the business, property, affairs and financial circumstances of the company (including any possible claim that may be taken by the liquidator of the company under any of sections 264B, 266 to 266B, 275, 276 or 295A to 295G of the Companies Ordinance (Cap. 32) if the company is being wound up as a creditors' voluntary winding up on the relevant date).*"

1.9.2 It appears that impliedly, the provisional supervisor himself / herself cannot invoke the avoidance powers, and the task of pursuing avoidance claims will fall on the liquidator mentioned therein. How claw-back periods should be prescribed, so as to avoid the avoidance powers being weakened by a preceding (unsuccessful) provisional supervision, is therefore an important issue.

1.9.3 Under the 2001 Bill, it is only with cross-references to the definition of the term "*relevant date*" (in clause 2) and clause 8 that a reader will appreciate clause 22(5)(b) indirectly and inferentially provides, *inter alia*, that for the purpose of reckoning claw-back periods the creditors' voluntary winding-up will be deemed to commence on the date when the provisional supervision commenced. We recommend that the new bill to be re-drafted should provide for this in clearer and more direct language.

1.9.4 At the same time, during the provisional supervision presumably the company (acting through the provisional supervisor and / or one or more of the directors) will inevitably make payments, given its business continues. If subsequently creditors' voluntary winding-up is deemed to commence, there appears to be no provision in the 2001 Bill which addresses the issue of whether or not such payments, if made to individual creditors, can constitute a preference or a void transaction. For the sake of certainty, express provisions in this respect are desirable.

2. HKAB's observations on and responses to the 19 questions

Question 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.**
HKAB's observations *Paragraph 2.4*

We agree that, realistically, filings with the Official Receiver and / or the High Court will not materially improve the efficiency of informing the public of the commencement of a provisional supervision.

Paragraph 2.5

The rationale for the proposed new requirement is not obvious to us. Section 40(2) of the Employees' Compensation Ordinance (Cap 282) already provides for criminal sanction against an employer which employs others without insurance cover. There is no obvious relationship between creditors' interests vis-à-vis the company and the existence or otherwise of employee compensation insurance. Chances are, a company in financial difficulty may choose to take the risk of not paying insurance premium. This is a company law issue, not a provisional supervision issue.

Paragraph 2.6

We are of the view this proposal can facilitate a provisional supervisor's work. The same reasoning applies to provisional supervisions initiated by shareholders, provisional liquidators or liquidators. The requirement to submit a statement of affairs at the meeting for appointing a provisional supervisor ought to be extended to apply to all scenarios in which the "voluntary" petitioning party has access to the information to be included in the statement of affairs.

Response to the question

The HKAB supports the proposals at paragraphs 2.4 and 2.6, but does not support the proposal at paragraph 2.5.

We further recommend that the proposal at paragraph 2.6 be extended to provisional supervisions initiated by shareholders, provisional liquidators or liquidators. In addition, the management of the debtor company should have the obligation to provide all books and records to the provisional supervisor.

Question 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.

HKAB's observations

As stated in our previous submissions, our view is that major creditors (whether secured or unsecured) should be given the power to initiate provisional supervision.[2]

[2] In this respect, as is pointed out at paragraph 2.3 of the 2009 Consultation Paper, "*Some other jurisdictions like the UK, Australia and Singapore allow creditors or major secured creditors to apply for corporate*

We note this is the case under the US Chapter 11 procedure, and although creditors there have the ability to petition for Chapter 11, petitions generally – and certainly in the higher profile cases – are usually filed by the debtor companies themselves rather than by creditors. If management realises that creditors have the ability to initiate corporate rescue procedures, it is in management's interest to take control of the process and commence the procedure itself. Therefore, it is possible that giving this power to major creditors may in fact encourage debtor companies (especially those which would otherwise be unwilling to deal with the problem early) to use the procedure.

Response to the question

The HKAB repeats the recommendation that major creditors (whether secured or unsecured) should be given the power to initiate provisional supervision.

Question 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.

HKAB's observations

Paragraph 2.7 of the Consultation Paper points out that "*creditors and stakeholders outside Hong Kong may not have equal access to Hong Kong newspapers.*" If a company about to enter into provisional supervision is required to put up a notice on its website(s), if any, this would address the issue to an extent.

In addition to advertisement in the local newspapers, debtor companies having substantial overseas operation should advertise in overseas newspapers where they have operations.

Response to the question

Please refer to the above as regards the means of giving notice.

We also repeat a previous submission that, under the present notice procedure, until receipt of notice, the relevant secured creditor cannot act. This will create a hiatus, permitting claims that otherwise would not have priority (such as the provisional supervisor's fees and expenses) to enjoy a priority out of floating charge component. We are unable to support a proposal which will lead to this result: in our view creditors (especially secured creditors) should be informed forthwith, preferably on "day 1".

rescue procedure as well." In our understanding, this has not caused any significant problem in those jurisdictions.

Question 4

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

HKAB's observations

In view of the proposed introduction of the first meeting of creditors within 10 working days from commencement, we consider 45 days to be a reasonable length for the initial moratorium period.

Response to the question

The HKAB supports this proposal. At the same time, we make the following submissions:

- The moratorium may work prejudicially for Hong Kong creditors. For example, where the company has assets or operations in Mainland China, the Mainland creditors will not be bound by the moratorium but may enforce their individual rights against the company's assets. This is a great concern. Even when a moratorium is in place, enforcement actions which bank creditors (whether based in Hong Kong or otherwise) may take and / or other steps to safeguard their interests outside Hong Kong (for example, in Mainland China) should not constitute a breach of the moratorium.

- Creditors should have more protection during the 10 days before the first meeting of creditors:

    - Before the first meeting of creditors is convened, the company should not carry out any transaction (such as but not limited to any substantial disposal of its assets, and the creation of new debts / borrowings / encumbrance / security in substantial amount) other than those in its ordinary course of business, unless approved by the Court.

    - If the initial provisional supervisor does not convene the first meeting of creditors within 10 days, the company should be deemed to be no longer in provisional supervision, and the moratorium should cease forthwith. To prevent abuse of this arrangement, such a company should not be allowed to commence provisional supervision again for a sufficiently long period, unless the procedure is initiated by its provisional liquidator, liquidator or major creditors.

- At the first meeting of creditors, creditors should be able to resolve to place the company into creditors' voluntary liquidation.

- The new legislation should make it clear that, if the beneficial ownership of an asset has already transferred from the debtor company to a creditor as a result of enforcement actions, or from a creditor to a third party, then that

asset should not be subject to the moratorium. In the same vein, if (1) a third party owed a debt to a company, (2) the company assigned the receivables to an institution (such as a bank), and (3) before the assignee has notified the third party, the assignor goes into provisional supervision, in our view the assignee should not be bound by the moratorium, notwithstanding that the assignment has not yet been perfected.

- The new legislation should also stipulate that a provisional supervision will only operate with respect to individual companies, but not on a "group" basis. Creditors should not be restricted from taking enforcement actions against assets owned by entities other than the company in provisional supervision.

Question 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.

HKAB's observations

We agree with the 2009 Consultation Paper that Court involvement should be minimised. Creditors are able to assess whether it is worth extending the moratorium up to six months, so it is appropriate that a proposal for extension up to six months should be referred to creditors in the first instance.

Response to the question

The HKAB supports this proposal.

At the same time, we can anticipate there may be situations where practical difficulties will arise if an extension can only be granted by creditors. For example, by the time the provisional supervisor forms a view that an extension is required, there may not be sufficient time that remains for him / her to serve notices to creditors and to convene a creditors' meeting. Also, some creditors having headquarters overseas may need more time than is available to arrange for internal clearance with respect to an extension.

To address this potential issue, we recommend that, if (and only if) supported by cogent reasons, to the satisfaction of the Court, explaining why it would be impracticable to seek an extension from creditors, the provisional supervisor be allowed to apply to the Court for obtaining an extension. In this scenario, creditors should have automatic right of audience.

Question 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.

HKAB's observations

While applying to the Court will involve extra costs, it is our hope that the need to seek from the Court extensions beyond six months will act as an incentive to provisional supervisors to finalise a rescue plan within six months.

Response to the question

The HKAB agrees with the proposal, subject to the following:

- At the hearing of the application for extension, creditors should have automatic right of audience.
- The Court should have the discretion to order that an extension be conditional upon such term(s) as the Court may deem fit, in order to ensure fairness to creditors generally and / or particular creditor(s), for example to exempt a particular secured creditor and / or particular asset(s) from the moratorium.

Question 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.

HKAB's observations

It is our hope that a moratorium for 12 months would be sufficient in most cases. If the maximum duration be any longer, in case a rescue does not succeed and the company has to be wound up, the liquidator's avoidance powers may become less effective.

That said, in our view the Court should be able to extend beyond 12 months provided there is majority creditor support.

Response to the question

The HKAB recommends that this proposal be amended to permit further extensions.

Question 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.

HKAB's observations

Previously the HKAB submitted that rights of set-off, quasi security rights and any other right, such as the right to retain control of documents of title, bills of lading etc. should not be affected by the legislation.

Response to the question

All unsecured debts repayable to creditors (whether actual or contingent) should rank *pari passu*.

As to pre-existing rights which a creditor may have, the HKAB repeats its previous submission stated above. If the intention is to allow counterparties of derivative contracts to enforce pre-existing security rights against the company, we fail to see why the same right should be deprived from bank creditors which hold similar security rights, given the close analogy between the two scenarios.

In addition, whilst it is acceptable to allow derivative contracts to continue, close out, etc, there should be no settlement in cash and / or in kind by the company (i.e. by any payment and / or transfer out of the assets of the company). The counterparty should instead only have a claim against the company if the counterparty is in the money at termination.

In relation to the Appendix in the 2009 Consultation Paper, we would propose the following changes:

1. Items to be added:

   (a) credit derivative agreement;

   (b) equity derivative agreement;

   (c) a derivative relating to bonds or other debt securities or to a bond or debt security index;

   (d) an energy derivative (such as electricity derivative, oil derivative, coal derivative or gas derivative);

   (e) a weather derivative (such as weather swap or weather option);

   (f) a bandwidth derivative;

(g) a freight derivative;

(h) an emissions derivative (such as an emissions allowance or emissions reduction transaction);

(i) an economic statistics derivative (such as an inflation derivative);

(j) a property index derivative;

(k) any security agreement or credit enhancement agreement (by way of title transfer or the granting of a security interest) related to an agreement or contract referred to in any of items 1 to [x];

(l) any other agreement, contract or transaction similar to any agreement, contract or transaction referred to in items 1 to [x] with respect to one or more reference items or indices relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instruments, precious metals, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value; and

(m) any agreement, contract or transaction designated as such by the Hong Kong Monetary Authority under the new legislation.

2. Items to be amended:

(a) Item 11 in the Appendix - we recommend amending this item to read "*Master agreement in respect of any agreement or contract referred to in any of items 1 to [x], including where such master agreement also documents or contains any transaction that is not exempted under Schedule 5. For avoidance of doubt, Section 11(2) does not apply to set-off and close-out netting across different derivative products, regardless of whether or not any master agreement is in place.*"

(b) Item 12 in the Appendix - we recommend amending this item to read "*Guarantee of the liabilities under an agreement or contract referred to in any of item 1 to [x], including where such guarantee also guarantees any liability under any agreement or contract that is not exempted under Schedule 5.*"

Furthermore, we recommend that the effect of the moratorium, as set out in clause 11(2) of the 2001 Bill, should be provided for in more detail. For example, when would a creditor be regarded to have taken steps "*to enforce or continue to enforce any security*" (clause 11(2)(d)) should be elaborated.

Question 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.

HKAB's observations

Employees' entitlements generally

The HKAB made the following submissions with respect to the bills in 2000 and 2001:

- Claims of employees should not have any priority from fixed charged assets.
- Claims of employees being met should not be a precondition to Provisional Supervision.
- The claims of directors and their associates (as defined in the Insolvency Act 1986) should be generally postponed.
- Under the 2001 Bill, security held by a lender not in the form of a fixed charge will be subject to priority claims by employees. In reality, lenders often take other types of security or obtain rights of security by operation of law such as pledges and liens. Such security interests should not be subject to priority claimants such as employees' claims and provisional supervisors' fees and expenses.

2003 Proposal

In our view the 2003 Proposal can hardly work in practice. If this option is chosen, we fear that the new legislation will have but little success. Even with a cap of HKD278,500 per employee, many companies will not have sufficient cash resources to pay their employees in full.

Alternative A

Under this proposal, leaving just one employee's entitlements unsatisfied is sufficient to upset an otherwise feasible rescue plan, because that employee can still, for example, petition for the company to be wound up. Realistically, all employees' entitlements must be satisfied in order to exclude any uncertainty. The net result will likely be the same as that under the 2003 Proposal. Individual employees will have unjustifiably substantial bargaining power. Accordingly, we are also not in favour of this proposal.

Alternative B

On comparison, whilst this proposal can be further improved, we consider it to be

the more attractive one among the three, in that it promotes the overriding principle of the intended new legislation, namely saving viable companies in short term financial difficulties. It is pointed out at paragraph 4.12 of the Consultation Paper that this proposal "*would require the expansion of the ambit of PWIF to cover creditors' voluntary winding up cases arising from the above scenarios where employees are not being paid the "employees' protected debts" under provisional supervision. It would relieve employees from having to present a winding-up petition against the company or seeking the assistance of the Legal Aid Department...*" In our opinion, extending PWIF coverage to voluntary liquidations is an appropriate move quite irrespective of whether Alternative B is adopted. Employees should be treated the same regardless of which insolvency procedure is used.

Response to the question

The HKAB repeats the submissions made with respect to the bills in 2000 and 2001.

As regards the three options, unless a better, new alternative is proposed, the HKAB supports Alternative B with the following changes:

- Employees' entitlements (including employers' MPF scheme contributions) which are in excess of the "employees' protected debts" under the PWIF caps should *not* have priority over other unsecured creditors. All unsecured creditors should rank *pari passu*. The proposal to pay outstanding entitlements of the employees in the first 12 months of the voluntary arrangement should be modified accordingly.

- Payments to substantial shareholders, directors and other closely related parties (such as personal guarantors of the debtor company), who also serve the company as employees and have claims for substantial unpaid wages, should be restricted.

- PWIF coverage should be equally available in all insolvency procedures.

- To address the perceived potential issue described at paragraph 4.16 of the Consultation Paper, there can be added a requirement similar to that found in sections 228A(4) and 233(3) of the Companies Ordinance (Cap 32): if a company is proposed to be put into provisional supervision, the initiator will have to sign a statement confirming that, in his / her opinion, it is proper to invoke this procedure, and signing the statement without having reasonable grounds for such an opinion can be made an offence.

Question 10

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

HKAB's observations

By their nature, MPF scheme contributions are meant to be invested and not be paid to the employees in the near future (with the exception of those who will reach retirement age soon). Instead of adding claims for these contributions to the employees' protected debt (to be settled in the initial phase of a provisional supervision), it should be sufficient if the rescue plan is required to provide that the company shall make good these contributions according to the timeframe for settling other debts that remain outstanding to employees.

The practical difference between our proposal and increasing the employees' protected debts is that, with our proposal, the contributions will be available for investment later (for example, by a few months). Depending on market conditions, this may or may not actually be prejudicial to the employees' interests. At the same time, our proposal goes some way in lowering the initial threshold.

Response to the question

The HKAB puts forward the proposal described above for the FSTB's consideration.

Question 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?

HKAB's observations

The HKAB is in general agreement with paragraphs 5.6 and 5.7 of the 2009 Consultation Paper. We note that the current proposal is the same as the requirement under section 228A(8)(b) of the Companies Ordinance.

However, since a provisional supervisor will (under the current proposal) be personally liable for new and pre-existing contracts entered into or accepted by him / her, it is important that appointment takers are covered by adequate professional indemnity. Given the magnitude of some administrations, the level of professional indemnity cover held by some solicitors and accountants may be inadequate.

We are of the view the merit of having a panel system outweighs the drawback: whilst it is acknowledged that a panel system may result in a closed shop, at least we anticipate this to be a closed shop of the more reputable insolvency practitioners. Compared with a winding-up, a rescue will likely require even more qualified

appointment-takers, because a company in provisional supervision or voluntary arrangement continues to trade, and the tasks of protecting the estate and acting in the best interest of creditors will likely be more demanding than in a winding-up.

In addition, if individuals other than those qualified to be admitted to a panel can accept appointments, we are concerned that the new legislation may be misused by a company with the co-operation / acquiescence of a "friendly" provisional supervisor, thus subject the company's assets to (*inter alia*) a risk of dissipation / unfair preference, especially in the first 10 days, during which much harm can be done to the company's assets and financial position.

Response to the question

Given there already exists the Panel A system administered by the Official Receiver, we see no need for yet another panel. We recommend that only Panel A members be allowed to accept an appointment to be a provisional supervisor.

In addition, we recommend that no provisional supervisor should be connected, or previously connected, with the company, for example where s/he is the company's accountant or auditor. There should be restrictions against an intended appointment if a situation of conflict exists.

Question 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.

HKAB's observations

Provided the voting method applicable in creditors' meetings is fair to independent creditors such as banks (e.g. creditors associated with the company have to abstain), in principle the HKAB welcomes the flexibility of allowing "ad-hoc appointments" in appropriate cases, although we anticipate these cases to be rare, especially given the alternative of having a solicitor or an accountant (or a Panel A member as we recommended) as the provisional supervisor assisted by someone with the suitable credentials as (effectively) a consultant.

If "ad-hoc appointments" are to be allowed, in our view the better approach is to have the Court making these appointments, rather than the Official Receiver. One advantage of this approach is that the Court already has a well-established appeal mechanism.

Response to the question

The HKAB supports the proposal to allow "ad-hoc appointments", with suitable candidates appointed by the Court rather than the Official Receiver.

Question 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.

HKAB's observations

Previously the HKAB submitted that the interests of creditors are of paramount importance in a provisional supervision, and accordingly creditors should be given the rights to decide matters pertaining to provisional supervisors. We welcome the proposal of allowing creditors to replace the initial provisional supervisor.

Response to the question

The HKAB supports the proposal.

Question 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).

HKAB's observations

The HKAB considers that the arguments in favour of personal liability set out in paragraphs 5.15 and 5.16 of the 2009 Consultation Paper are valid.

The risk that a provisional supervisor may face in this respect is (in our view, adequately) offset by his / her right, in ordinarily cases, to be indemnified out of the assets of the company:

1. This right is lost if there is misconduct or negligence on his / her part, but in this scenario he / she can hardly deserve to be indemnified (consistent with this, a liquidator may likewise have to bear his / her costs personally in an analogous scenario).

2. This right has no real value if the company has insufficient assets, but a candidate can avoid the problem by making enquiries before accepting an appointment (we note this point is made at paragraph 5.16(a) of the 2009

Consultation Paper).

Response to the question

The HKAB supports the proposal of imposing personal liability on provisional supervisors.

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.

HKAB's observations

The HKAB notes that other major common law jurisdictions, such as the United Kingdom and Australia, have introduced insolvent trading provisions. It is appropriate that Hong Kong catches up with other jurisdictions in this respect.

Response to the question

The HKAB supports the introduction of insolvent trading provisions, and considers this to be a key part of the proposed legislation.

Question 16

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

HKAB's observations

Exclusion of "senior management"

The HKAB notes the points made in paragraph 6.5(a) of the Consultation Paper.

Dropping the test of "reasonable suspicion of insolvency"

Our view with respect to the two tests stated in paragraphs 6.1(1)(a) and (b) of the Consultation Paper (in summary, (a) actual or constructive knowledge of insolvency and (b) reasonable suspicion of insolvency) is set out below:

1. The conceptual difference between the two tests is delicate.

2. It is also difficult for another party (such as a bank dealing with a director of a debtor company) to assess whether that director would have a "reasonable suspicion of insolvency". Whereas knowledge is a "yes / no" issue, suspicion is a matter of degree.

3. If this two-limb test is enacted, at least before we have a large body of case law, the business community will not find that this test gives clear guidance.

4. If a reasonable suspicion of insolvency suffices for liability to attach, this means liability can arise even if the company is actually not insolvent. This appears to be stricter than necessary.

Response to the question

Exclusion of "senior management"

If there is to be insolvent trading legislation, the net need not be cast too wide initially. Given the divergent opinions as to whether senior management should be covered, the better course is not to include it for the time being, and see how the regime will work. In future, if it becomes evident that senior management should be included, this can be effected by a simple amendment to the legislation.

At the same time, if senior management is to be excluded, in our view there should be a corresponding increase in the duties on the part of the directors, for example by imposing a positive onus to make enquiries as regards the financial position and prospects of the company.

Dropping the test of "reasonable suspicion of insolvency"

The HKAB supports the proposal.

Question 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.

HKAB's observations

The HKAB agrees with paragraph 7.7 of the 2009 Consultation Paper, where it is remarked that to define a "major" secured creditor by reference to a particular percentage of the company's assets "*would result in delay due to valuation and calculation difficulties*", especially given a rescue is time-critical.

Response to the question

The HKAB agrees that there should be no percentage references in the definition of "major secured creditors". In addition, we repeat the following submissions made previously:

- The Major Creditor (then as defined in the 2000 bill) should be a holder of a charge (and, we would add, other forms of security interests or quasi-security interests, some of which are mentioned above) over the whole or substantially the whole of the company's property. In the usual case the business assets would be subject to a floating charge and the holder of such

charge should be the Major Creditor.

- A number of secured creditors collectively holding security over all or substantially all of the company's assets should also have the rights proposed to be given to a single major secured creditor.

Question 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.

HKAB's observations

We are unable to find where in the 2009 Consultation Paper are the following submissions and recommendations by the HKAB with respect to the bills in 2000 and 2001 addressed:

- The holders (in aggregate) of a floating charge(s) over the whole or substantially the whole of the company's business assets and undertaking should be able to veto the procedure.

- Rights conferred by long-standing and well-understood security rights, such as the right of a major secured creditor to immediately enforce its security on the occurrence of an event of default, must not be affected or compromised by the legislation. Examples would include (a) the right to enforce security without delay on the appointment of a provisional supervisor (which is compromised by virtue of clause 19 of the 2001 Bill) or the right of a financier to retain control of documents of title, bills of lading and so on, and (b) the inability of creditors to exercise their rights of set-off or presumably combining of accounts except with the consent of the Provisional Supervisor, as proposed in the 2001 bill.

- The proposed priority of super priority lending and the indemnity of the provisional supervisor's liabilities and remuneration over all other claims pursuant to Part 4 of Schedule 4 of the 2001 Bill compromises well established rights afforded to banks. It would enable a new money lender priority in respect on their fresh advances, or in the case of the provisional supervisor, priority in respect of their fees and liabilities incurred by them. This priority extends to any non-fixed charge security that the bank enjoys, such as deposit accounts (notwithstanding a right of set-off) and documents pledged by way of security. This will further diminish the contractual or security rights which the banks may otherwise have.

- Secured creditors should be entitled to vote in respect of any proposal for all their debt and not just the unsecured portion, given they are restricted from

enforcing their security during the moratorium.

Response to the question

The HKAB repeats the previous submissions set out above and recommends that the bill to be re-drafted should address them.

Improvements in the 2001 Bill over the 2000 Bill should be retained. In particular, we recall the 2000 Bill actually permitted the creditors' meeting to approve a proposal that directly impairs the rights of secured creditors. The 2001 Bill expressly changed this result and provided that the creditors' meeting could not vote to modify the rights of a secured creditor, except where such secured creditor gave his consent. *This feature of the 2001 Bill must be included in the re-draft of the bill to be prepared in due course.*

Question 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?

HKAB's observations

As is noted in paragraph 8.4 of the 2009 Consultation Paper, the possibility of "debt splitting" does exist.

In paragraph 8.3 of the 2009 Consultation Paper, it is explained that "*In the past, the headcount test was served as a means to ensure that employees' and small creditors' voices are heard*". In our view, the current proposals already include sufficient special treatments to protect employees' interests in recognition of their (perceived) vulnerability. The explanation given in the 2009 Consultation Paper does not justify the potential of the headcount test to distort voting.

Response to the question

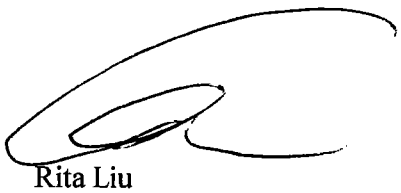
The HKAB recommends that the headcount test be removed.

Whilst not directly related to question 19, we also observe that footnote 40 under paragraph 8.1(c) in the 2009 Consultation Paper refers to the concept of "*an associate*" "*within the meaning of section 51B of the Bankruptcy Ordinance*". The problems with applying to the context of windings-up, the definition of associates in personal bankruptcy, are well documented and should be avoided in the new legislation.[3]

[3] For example, the late Professor Philip Smart pointed out in an article appearing on page 15 in the June 1997 issue of the Hong Kong Lawyer (entitled "*Unfair Preferences*") that spouses and relatives of the directors of the debtor company do not come within the statutory definition of "*associate*", even though they are among "*the most obvious people who ought to be subject to the stricter regime*".

We hope you find our submission to be of assistance. We conclude by repeating that we would like to participate in the limited consultation, during which we can further explain the points made above.

Yours faithfully,



Rita Liu
Secretary

c.c. Hong Kong Monetary Authority (Chief Executive)

Similarly, under the current definition a holding company is not an associate of its subsidiary. In the situation where a debtor company makes a payment to its holding company purportedly to settle a shareholder's loan, the payment cannot be characterised as one in favour of an associate.
Furthermore, directors of the debtor company are its associates, but only because they are "*treated as employed by*" it (section 51B(4), Bankruptcy Ordinance), and therefore the presumption of a desire to prefer does not apply in a claim against a director (section 50(5), Bankruptcy Ordinance).