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By Hand

Division 4, Financial Services Branch
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
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29 January 2010

Dear Sirs

Corporate Rescue Procedure Legislative Proposals

We are pleased to provide our submission on the Corporate Rescue Procedure Legislative Proposals.

We welcome the introduction of a Corporate Rescue Procedure in Hong Kong. We believe that a major financial centre like Hong Kong should, like many other jurisdictions, have a legislated rescue and turnaround regime that assists in saving employment and economic value that are both lost when companies fail.

To facilitate your review, we have set out our submission in the same format as the Reply Form.

We trust that our submission assists in the review of the Proposal. We would be happy to meet with you to discuss our submission or any issues you would like to raise with us.

Please contact me on or by email ( ) to discuss or clarify any matters further.

Yours faithfully

Anthony Boswell
Partner
PricewaterhouseCoopers

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.

The 3 proposals are:

2.4 To require the notice of appointment and documents to be filed with only the Registrar of Companies, which will be accessible to the public through Registry's electronic search services. There is no need to file the notice and documents with the OR or the High Court.

2.5 To require a company to confirm before the commencement of provisional supervision that it has in place a valid insurance policy to cover its employee compensation liabilities.

2.6 To require that the statement of affairs of the company be submitted to the provisional supervisor at the directors' meeting that decides to appoint a provisional supervisor.

Para 2.4

Analysis

The proposal as drafted reduces less important formalities in the first few days of provisional supervision and enables stakeholders to focus on the potential turnaround process.

We consider it is sufficient to file appointment documents with the Company Registrar provided that the records are up to date. The public have ready access to such information by performing company searches.

Submission

We support the proposal to simplify the formalities to commence the provisional supervision.

Under our recommendations for licensing of provisional supervisors (see page 9), the Official Receiver would be notified as part of the process and in that case the notification regime would necessarily be different.

Para 2.5

Analysis

Companies are required by law to take out workman compensation insurance, failure to do so constitutes a breach of the law and the directors are subject to prosecutions by the relevant government authority. Directors should be held personally liable in respect of any potential claims arising from such a breach. This may serve to encourage directors to seek help earlier to deal with their financial difficulties.

Submission

We submit that failing to have a valid insurance policy should not bar companies from undertaking a turnaround of its business.

Para 2.6

Analysis

The directors are expected to have a reasonable basis for appointing a provisional supervisor based upon financial information about the business. Requiring a director to submit the Statement of Affairs to the provisional supervisor at such meeting that decides his appointment serves as a check that there are reasonable grounds for so doing. It also provides the provisional supervisors with an overall picture of the Company's financial position, which should be the first step for formulation of a voluntary arrangement proposal. The requirement should not be difficult to comply with as directors are expected to have a reasonable set of financial accounts readily available. Realistically, without the Statement of Affairs, the provisional supervisor cannot carry out his/her work properly.

However, we recognise that there may be special circumstances where this is not possible. To cater for such circumstances, we propose that the provisional supervisor, by exception, be allowed to grant the directors' an extension of up to 5 working days from the date of the meeting.

Submission

We support the proposal to require the directors to submit a statement of affairs. In exceptional circumstances, the provisional supervisors should be allowed to grant an extension.

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.

Analysis

Creditors have been intentionally excluded as initiators on the belief that:

- they would not have the knowledge required to assess the viability of the business;
- if they are the major secured creditors, the management would in any event have to obtain the prior support of the major secured creditors if they wish to initiate provisional supervision; and
- creditors would be able to encourage management to initiate provisional supervision anyway.

In practice, creditors are becoming more sophisticated. Large creditors often engage independent professionals to assist them in conducting business reviews when they believe their exposure is reaching uncomfortably high levels.

Also, the approval of the voluntary arrangement proposal requires the support of the creditors who need to be comfortable with the proposed provisional supervisors. As they have the right to replace the provisional supervisor at the first creditor meeting, which could be highly disruptive, it would seem sensible to permit them to initiate the process and appoint provisional supervisor in the first instance.

To avoid abuse by creditors, a threshold should be set requiring minimum creditor value. In practice, major bank creditors usually meet among themselves to consider possible options in respect of a company in distress (including the appointment of independent financial advisor to conduct a business review or the appointment of provisional liquidators).

Submission

We submit that secured creditors should also be allowed to initiate the rescue procedure. To avoid an abuse of the system and to balance the interests among creditors, a threshold value should be set for creditors who wish to initiate the procedure. We also submit that if secured creditors were allowed to apply for corporate rescue, they should be required to obtain Court sanction to do so.

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.

Analysis

The notice of appointment of provisional supervisors should be published as soon as practicable once the provisional supervisors are appointed. Ideally, it should be published on the same date as the last document filed with the Registrar of Companies. However, there may be practical issues which prevent this. Local newspapers usually require 1 day's lead time for publishing an advertisement. It is not reasonable to delay the initiation of the procedure simply because the advertisements could not be made on time.

Submission

We submit that the notice should be published on the day following the filing with the Registrar of Companies.

Question 4

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

Analysis

Generally, we support the initial moratorium period of 45 days. However, if it coincides with holiday periods (such as Christmas, New Year, Chinese New Year and Easter), the number of working days available to the provisional supervisor could be significantly reduced.

Submission

We support the extension of the initial moratorium period to 45 days, which is approximately 40 working days. We further recommend the initial moratorium period should be 40 working days (i.e. excluding Sundays and public holidays), thereby reducing the impact of potential holiday periods.

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.

Analysis

The current proposal rightly gives the creditors more control over the process and reduces the need to go to Court for approval which is a costly and time-consuming exercise. As for the length of the extension, we expect that six months would generally be sufficient in most cases.

Submission

We support the proposal to allow for extension of the moratorium period up to a maximum period of six months from the commencement of provisional supervision.

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.

Submission

We agree any extension beyond six months should only be permissible upon court approval.

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.

Analysis

It is difficult to rule out the possibility of exceptional cases of a complex nature which may justify a moratorium of more than 12 months. Such extension should be subject to the Court's discretion.

Submission

Whilst we agree that the procedure should not be extended without limit, we submit that a maximum of 12 months from the start of the procedure be set as a guidance to the Court and the Court should then have discretion in exceptional circumstances if the provisional supervisor requires more time to formulate a plan.

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.

Submission

We see no area for specific revision.

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.

Analysis

	Alternative A	2003 Proposal	Alternative B
Setting up a trust fund?	- exempt employees who are owed wages or other entitlements from the moratorium - preserve their rights to petition to the Court to wind up the company during the moratorium	**YES** A trust fund with a cap mirrors the compensation paid by PWIF in a liquidation is required to be set up before the start of provisional supervision	**NO**
Payment of outstanding entitlements within the cap		To be paid by the provisional supervisor asap after the commencement of provisional supervision <u>but before the second meeting of creditors (i.e. not later than 45 days of provisional supervision)</u>	To be paid by the provisional supervisor asap after the commencement of provisional supervision <u>but not later than 60 days of provisional supervision</u>
Payment of any outstanding entitlement above the cap		Within 12 months from the approval/ start of Voluntary Arrangement	Within 12 months from the approval/ start of Voluntary Arrangement

Alternative A exempts employees who are owed wages or other entitlements from the moratorium. This requires the company and provisional supervisor to acquire external funding to avoid employees from taking enforcement action against the company during the moratorium and execution of the voluntary arrangement. This introduces significant uncertainties to the process. The provisional supervisor may be forced to divert his/her limited resources to addressing all outstanding employee claims to the detriment of the voluntary arrangement proposal. This poses significant pressure on the provisional supervisor and elevates the rights of the employees so that they are better off than what they would be in a liquidation. We believe that revival of a distressed company benefits not only the creditors but also the employees who are also stakeholders, in providing them with continuing employment. All stakeholders (including the employees) should be bound by the moratorium before the procedure starts.

2003 Proposal requires the troubled company to set up a trust fund with a cap equivalent to the compensation which would be available to employees under Protection of Wages on Insolvency Fund Ordinance ("PWIFO"). This proposal protects those employees who are owed wages. However, it presents a significant impediment to using provisional supervision. One of the warning signs of distress is that companies are unable to meet employees' entitlements. Requiring a company with financial distress to set up a trust fund to provide for outstanding entitlements which mirrors the compensation available under the PWIFO is unrealistic and likely to be too harsh a condition to initiate the rescue procedure.

Alternative B does not require a company to set up a trust fund to cover outstanding employee entitlements before the initiation of the procedure but the company has to settle all outstanding employees' entitlements as per the compensation available under the PWIFO no later than 60 days from the start of the procedure. The remaining outstanding balance has to be settled within 12 months from the start of the procedure. We note that this proposal requires amendments to the PWIFO and that extra funds may need to be injected to the Protection of Wages on Insolvency Fund ("PWIF").

Submission

We support Alternative B with further modifications. We submit that the PWIF should be used to fund the required payment of the outstanding employee entitlements (mirroring the compensation available under the PWIFO). In the event that the voluntary arrangement is successfully approved, the company should immediately repay the PWIF. In the event that the voluntary arrangement is unsuccessful and the company is put into Creditors' Voluntary Liquidation, the PWIF would then have a subrogated claim in the liquidation of the company. This change allows the provisional supervisors to concentrate on formulating the voluntary arrangement proposal rather than diverting their efforts to raise funds solely for this purpose.

We realise this system may be subjected to abuse in that companies may initiate the procedure to shift the burden of payment to the PWIF. However, if the company cannot be revived, the claim against PWIF is inevitable anyway, in this respect, it is a timing issue not an additional burden.

We submit that for voluntary arrangement to succeed, it is absolutely vital to retain the continued support of employees in the business. Special treatment has been accorded to employees under the proposed Bill. However, a balance of interest must be struck and we think that Alternative B as modified, provides a solution.

If PWIF is unable to take up this role due to its limited ambit, we recommend that a dedicated fund be set up for this purpose by the government and funded by it.

Question 10

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

Analysis

The employers' MPF scheme contribution is comparable to salary due to employees and it is a requirement by law and hence should be included in the calculation of outstanding employee entitlement and be treated in the same way as other outstanding employee entitlements.

Submission

We believe that the MPF scheme contribution should be included in the calculation of outstanding amount due to the employee and be treated in the same manner as employees' wages and other outstanding entitlements under the Employment Ordinance.

Question 11

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

Analysis

In deciding upon the suitability of appointment of provisional supervisor, we consider that considerable emphasis should be placed on relevant experience and the availability of suitably qualified resource which the candidate can field to assist him/her. The provisional supervisor needs to be able to grasp the business fundamentals very quickly, stabilise the business, conduct appropriate financial analysis and form a view as to the viability of the business.

Submission

We believe that this is a fundamental issue in the success of the provisional supervision regime. We consider that suitability should not be determined by reference to merely holding a practising certificate issued under the LPO or registration in accordance with the PAO, under which there are many professionals who do not have the skills or experience to act as a provisional supervisor.

We submit that a licensing system for provisional supervisors (building on the existing panel A system for appointment of Liquidators in Court liquidations) should be established to promote and maintain a high standard of eligibility and conduct of provisional supervisors in

order to bolster confidence of stakeholders in the voluntary arrangement system. We further submit that the Official Receiver's Office is the most appropriate authority to assume the role of establishing and administering the licensing system. We recognise that the Official Receiver's Office will need to be able to increase its resources for this purpose.

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.

Submission

In respect of our submission in response to question 11 above, we submit that a licensing system should be introduced to establish eligibility and standard of provisional supervisors. Such system would focus on experience and available resource. As such only licensed individuals should take appointments.

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.

Submission

We agree with 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).

Analysis

We consider that imposing personal liability on provisional supervisors would bring about the following benefits:

- it would give confidence to creditors of companies that are experiencing financial difficulties which in turn have a stabilising effect on the business; and
- it may assist in reducing debtor-friendly provisional supervisors and discouraging "unqualified" persons from taking appointments.

However, to allow flexibility, provisional supervisors should be able to contract out of the personal liability on a case by case basis if agreeable by all parties concerned in the particular transaction.

In addition to the personal liability, provisional supervisors should be required to take out insurance cover so as to enhance the protection to stakeholders. This is necessary because the potential losses suffered by stakeholders, especially in sizeable cases, may far exceed the personal assets of provisional supervisors. However, further considerations have to be given to the availability and costs of such insurance cover.

Submission

We support the proposal of imposing personal liability, subject to the provisional supervisor having an indemnity out of the assets of the company to which he or she has been appointed. We submit that the provisional supervisor should be able to contract out of personal liability if it is agreed to by the contracting party.

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.

Analysis

The insolvent trading provisions impose personal liability on responsible persons (i.e. directors and shadow directors) of a company for debts incurred by the company when trading whilst insolvent. We believe that the threat of personal liability encourages responsible persons to exercise greater care in the management of their business and serves as an incentive for them to be more proactive and take remedial action at an earlier stage.

As the responsible persons include independent non-executive directors, we believe that the provision would improve corporate governance. In order to discharge their duties in a responsible manner, they would need to be more engaged in understanding the financial position of the company and overseeing the conduct of management.

For directors who have already given unlimited personal guarantees in favour of the creditors of the company (mostly the banks), the insolvent trading provision would have no additional financial impact.

The counter argument to insolvent trading is that it may discourage risk-taking entrepreneurship and thereby result in fewer new businesses and employment opportunities. We believe the reverse is true. That is, insolvent trading provisions will enhance responsible governance processes and lift the standard of corporate governance.

Directors who allow companies to continue to incur liabilities and therefore deplete company assets available to third party creditors when they knew or ought to have known the company was insolvent should be held accountable.

Personal liability of the directors becomes an issue in the event the corporate entity is placed into formal insolvency. The Liquidators may commence legal action against directors for insolvent trading. However, the Liquidators often lack the necessary funds to commence such litigation and in addition, successful actions are not guaranteed; litigation is costly and recoveries are uncertain.

Submission

We support the introduction of insolvent trading provisions.

Question 16

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

Analysis

There are two main changes.

The first is the exclusion of senior management from the definition of responsible person. This is reasonable because:

1. it is difficult to define senior management;
2. not all senior management will be in a position to have a robust understanding of the company's financial position; and
3. some senior management merely execute the instructions made by directors and it would be unreasonable to hold them responsible for decisions not made by them or outside their control.

The second change relates to the increase in the threshold for establishing insolvent trading, i.e. mere suspicion will not suffice. The standard is an objective standard of a reasonable director i.e. that the director knew or ought to have known.

Submission

We submit that the two changes are reasonable.

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.

Submission

We support the definition of "major secured creditors" in the 2001 Bill.

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.

Analysis

The Bill protects the rights of secured creditors in that they are allowed to opt out if they do not agree with the voluntary arrangement proposal and gives "major secured creditors" a right to decide upfront whether to participate in the provisional supervision within 3 working days of the notice.

In the absence of a reply from the major secured creditor, the Bill proposes that the provisional supervisor proceeds with formulating the voluntary arrangement proposal. We consider that the costs of putting the company into provisional supervision are too high without confirmation of support from the major secured creditors prior to proceeding.

Under the 2001 Bill, secured creditors who have indicated that they will participate in the provisional supervision are not allowed to vote on the voluntary arrangement proposal except to the extent of their ordinary unsecured debt. We consider that the overall support of major secured creditors is important to the success of the voluntary arrangement and that they should be allowed to vote and be bound by the voluntary arrangement.

Submission

We support the protection of all secured creditors' rights and submit that:

1. major secured creditors should be notified within 1 working day of the appointment of provisional supervisor and be given 7 working days to reply to the provisional supervisor on whether to participate in the provisional supervision.
2. the major secured creditor should be allowed to vote on the voluntary arrangement and be bound by it.

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?

Analysis

Removing the "headcount test" would:

1. help to streamline the process (less administrative work for the provisional supervisor)
2. gives more power to creditors with bigger exposure to the company
3. prevent abuse as noted in the recent case relating to the privatisation of the shares in a listed company where shares were split on the eve of the shareholders' meeting to meet headcount requirement and manipulate the outcome.

Submission

We submit that the head-count test be removed.