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Mr. John Leung, JP
Deputy Secretary for Financial Services and the Treasury
Division 4, Financial Services Branch
Financial Services and Treasury Bureau
15/F, Queensway Government Offices
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Dear Mr. Leung,

We are pleased to respond to the request for comments sought by the Financial Services and Treasury Bureau (FSTB) in relation to its consultative paper entitled, "Review of Corporate Rescue Procedure Legislative Proposals" (*Consultation Paper*). Our submission will not respond to all of the questions posed in the *Consultation Paper*. Rather, we will limit our comments to two areas of particular interest in regard to the enactment of a provisional supervision regime in Hong Kong: (1) the treatment of employees' outstanding entitlements; and (2) the need for the inclusion of an approach that provides for retention of management in some cases (a hybrid Debtor-in-Possession or DIP approach). At the outset, we wish to make clear that we are not advocating an American-style DIP regime for Hong Kong. Rather, for reasons set forth herein we recommend that Hong Kong enact a modified DIP approach with various checks and

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balances that would prove attractive to debtors and creditors alike, and that would provide a useful alternative for facilitating corporate restructuring in Hong Kong.

Our submission makes reference to the discussions at the 22 January 2010 symposium entitled, "Corporate Rescue in Hong Kong: The Government's 2009 Legislative Proposals" (the Symposium), jointly hosted at the University of Hong Kong by the Institute of Asian-Pacific Business Law (IAPBL) at the William S. Richardson School of Law at the University of Hawai'i at Manoa and the Asian Institute of International Financial Law (AIIFL) in the Faculty of Law at the University of Hong Kong. Our submission expands upon our comments made at the Symposium, as well as responds to comments and concerns espoused by other Symposium participants.

(1) The Treatment of Employees' Outstanding Entitlements

Revisiting the 2003 Proposal (requiring that prior to the initiation of provisional supervision the debtor must satisfy workers' entitlements up to a cap of HK$278,500 per worker, either in cash or though the establishment of a dedicated trust account)

We view the 2003 Proposal as the weakest of the options for addressing the treatment of workers' entitlements. We note that only a minority of the Symposium participants spoke favorably about the 2003 Proposal.

We take as a premise that companies that can afford to pay employment claims in full on the eve of provisional supervision will have better options available to them than provisional supervision. If a debtor has ordinary income, its creditors would likely prefer to negotiate a payment plan rather than force it into provisional supervision. By implication, then, companies with no alternative to provisional supervision would need new funding to make payments on the employment claims, or deplete funds that might be necessary for the restructuring to succeed.

It is expected that in the wake of the Asian Financial Crisis of the late 1990s and the current global credit crisis, companies in distress will face great difficulty borrowing as banks tighten their lending standards in response to the worsening business environment. Nonetheless, several Symposium participants pointed out that funds are still available where fund providers see a meaningful opportunity for returns. However, funds used to pay old debts cannot be used to continue and grow the business; therefore, requiring new funds be used first to satisfy employment claims reduces the prospect that new funds will generate returns for the providers. Thus, bankers and other possible financial sources would likely view such use as financial waste and prove unwilling to provide funds for this purpose.[1] In effect, requiring upfront payment of all employment arrears would in most cases preclude reorganization under provisional supervision as an

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[1] See Philip Smart & Charles D. Booth, *Provisional Supervision and Workers' Wages: An Alternative Proposal,* 31 HONG KONG LAW JOURNAL (2001) 188, 193.

option and, ironically, precipitate the winding up of the very companies that provisional supervision was intended to assist.

Moreover, in the absence of outside funding to satisfy workers' entitlements, corporate debtors in distress would quite likely refrain from paying trade and bank creditors, with a view to hoarding as much cash as possible for workers. This would be an undesirable consequence and further hinder the ability of such debtors to operate with the support of their creditors.[2]

Alternative A - Exempting Employment Claims From the Moratorium

As noted in the *Consultation Paper*[3] and also by several Symposium participants, the main critique of Alternative A is that giving the employees the right to petition for liquidation at any time increases the uncertainty for creditors in provisional supervision and decreases the likelihood of facilitating a successful reorganization. In the words of one Symposium participant, preservation of that right gives employees "gunpoint" bargaining power: the employees would be in position to demand upfront payment in full as a condition of allowing the reorganization, to the detriment of the reorganization and other creditors.

This uncertainty is of course based on the unknown propensity of the courts to grant liquidation even when other interested parties are committed to the process, and repayment of employment arrears is contemplated. One contra example raised in the Symposium was that of the UDL Group, a victim of the Asian Financial Crisis of the late '90s, in which the court refused to grant an order for a winding up even after much procedural maneuvering.[4]

Still, as the Symposium made clear, many creditors' groups and insolvency practitioners are not in favor of this alternative due to the inherent uncertainty that it creates. We agree.

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[2] *See id*. (Noting that this would, in turn "create what, in other circumstances, might be condemned as a preference.")

[3] *See* para. 4.6, at p. 22,

[4] *See UDL Argos Engineering and Heavy Industries Co Ltd v Li I Lin* [2002] 1 HKC 172, [2001] HKCFA 53 (3 December 2001) (HKLII). The relevant portion of the decision may be found in Stephen Briscoe & Charles D. Booth, HONG KONG CORPORATE INSOLVENCY MANUAL (2nd ed., 2009), at pp. 179-180.

Alternative B - 45-Day Delay in Payment on Employment Claims

Other creditors and possible DIP lenders would be more amenable to reorganization if payment on employment claims were delayed until 45 days after the initiation of provisional supervision. While a 45-day delay in payment may look less advantageous to employees in contrast to the two options set out above, it should be noted that: (1) practically speaking it should not delay actual payment, as the *Consultation Paper* recognizes, over the liquidation option; (2) it still places employees in a better situation than their counterparts in all other countries with corporate rescue regimes; and (3) unlike the other two options noted above, it dramatically increases the likelihood that workers can get paid **and** the debtor company may be rescued. As was stated by many participants at the Symposium, the challenge is convincing labour that they are not getting a bad deal under this alternative.

However, it is equally important to note that a successful reorganization requires the support of current employees. Even though the employees' situation under Alternative B places employees in a very strong bargaining position, it creates an inherent conflict between employees who want immediate payment for arrears and timely payment on future services, and the provisional supervisor who seeks to safeguard the debtor's remaining assets for purposes of reorganization. Employees may not agree to wait 45 days to be paid for work performed before and after the commencement of the provisional supervision. This tension suggests a slightly modified arrangement that emerged at the Symposium, discussed here as Alternative C.

Alternative C - Earlier, Staggered Payments on Employment Claims

Because of labour's strong bargaining position, a more practical alternative to Alternative B would be to begin paying on employment claims earlier in the restructuring but at a lower initial cap.[5] Under one such proposal broached at the Symposium, within 20 days of the commencement of provisional supervision, the provisional supervisor would have to pay employees' wages and other arrears, but not severance payments, up to a certain cap, *e.g.*, HK$21,000 or HK$36,000. Then, within 45 days of commencement, the provisional supervisor would be obliged to cover up to, say,

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[5] The *Consultation Paper* noted that Professor Booth and the late Professor Philip Smart put forward a similar proposal to Alternative B back in 2001. *Consultation Paper*, p. 23, n. 25. *See* Smart & Booth, *supra* n. 1, at 195-198. This "alternative proposal" provided that "every proposal by a provisional supervisor for a voluntary arrangement … must contain a provision to the effect that any outstanding employees' protected debts will be immediately satisfied in cash upon the voluntary arrangement coming into effect." *Id.,* at p. 197. Moreover, the recommendation was for the proposal to be put to the creditors' meeting within an initial moratorium of 30 days, and if the moratorium were to be extended by the court the legislation should expressly state that the moratorium could not be extended unless the provisional supervisor undertook to pay all of the employees' protected debts within 14 days of the court granting the extension. Thus, it was envisioned that in the ordinary course of events, workers might well be paid within 30 days of commencement of provisional supervision and, in any event, within 45 days.

HK$60,000 of wages and arrears. This compromise would provide employees with adequate assurance of timely payment, would thereby mitigate conflict between the employee and the provisional supervisor, and would thus provide an incentive for employees to remain with the debtor.

Alternative D - Expanding the Role of the PWIF (or Creating a New Fund) to Satisfy Employment Claims in Provisional Supervision Cases

The existence of multiple entrances to bankruptcy is often an accident of history and renders the process hostage to past precedent. Having multiple entrances allows different interested parties to initiate conflicting insolvency processes. This unfortunately is the current situation in Hong Kong as demonstrated in the following table:[6]

Comparison of Treatment of Outstanding Workers' Wages Under Various Insolvency Procedures

Type of Case	Compulsory Winding Up	Creditors' Voluntary Liquidation	Receivership	Provisional Supervision (the Corporate Rescue Bill)	Alternative Proposal (Suggested by Smart & Booth)
Amount	HK$36,000 (max)* from PWIF	HK$8,000 (max) under s 265, as preferential creditor	HK$8,000 (max) under s 79, as preferential creditor	All debts (no limit)	HK$36,000 (max) as employee protected debt in provisional supervision
Time Limit	No wages outside 4-month period	No wages outside 4-month period	No wages outside 4-month period	No time limit	No wages outside 4-month period

* In a compulsory winding up, an employee's claim as a preferential creditor for outstanding wages is HK$8,000; that sum is often claimed by the PWIF, having already made (larger) payments to the employee from the Fund.

A significant weakness of Alternative A is that it continues this trend and creates yet further conflicting incentives. So long as the workers are of the view that they will do better in a compulsory liquidation, they will be motivated to disrupt the restructuring

[6] Which originally appeared as Table 1 in Smart & Booth, *supra* n. 1, at p. 194.

being pursued in the provisional supervision, and thus create yet more uncertainty that would most surely drive new funding away and scuttle the rescue attempts.

It is therefore important to reduce the possibility that certain creditors, acting in pursuance of their own parochial interests, would force the liquidation of a company with good restructuring prospects. One simple way to eliminate cross incentives is to provide upfront payments on employment claims, as by expanding the role of the Protection of Wages on Insolvency Fund (PWIF or the Fund) to extend to provisional supervision. It should be noted that although the FSTB stated that Professors Smart and Booth put forward a proposal that was similar to what emerged as Alternative B, that was actually Smart and Booth's back-up proposal. Smart and Booth argued: "These commentators would respectfully agree with the LRC [Law Reform Commission] that the most rational approach to workers' wages would be to extend the PWIF to provisional supervision."[7] They noted that they were putting forward an alternative proposal "in light of the refusal to extend the ambit of the PWIF."[8] We would suggest that Alternatives B and C above should only be considered in the absence of support for extending the PWIF to provisional supervision cases – or perhaps creating a new fund – what we are now calling Alternative D.

Using the resources of the PWIF at first instance to satisfy employment claims would free up much-needed capital for the restructuring, as well as eliminate the risk of past and present employees disrupting the process.

Several Symposium participants noted that the Fund would be no worse off by doing so: if the restructuring ultimately failed, the PWIF would be in no worse position than if the company had liquidated from the outset. The Fund would also be granted a right of subrogation, so that if the restructuring succeeded, the Fund could recoup at least a portion of the amounts it paid on the debtor's employment claims.[9] In such a case, the upfront payment on employment claims would be, in an economic sense, a bridge loan.

In our view, expanding the role of the PWIF (or other government fund) in this fashion provides the best scenario for corporate rescue. With PWIF payments on employment claims in provisional supervision there will be greater residual value in the company for existing creditors or to entice a white knight or new lender. To the extent, then, that the debtor can rely on the PWIF for help in meeting its employment arrears in provisional supervision, the PWIF will have a greater chance of recouping the amounts paid out on such arrears.[10]

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[7] *Id.,* at p. 195.

[8] *Id.,* at p. 196.

[9] These, and related, arguments are set forth in *id.,* at pp. 195-96.

[10] This is particularly the case for small-sized and medium sized enterprise (SME) debtors, particularly labour-intensive operations, for whom employees' long-term service benefits may reach up to

It cannot be ignored, however, that the current board of the PWIF itself might not be amenable to expanding its ambit to include restructuring. As one Symposium participant noted, the PWIF currently has a right of subrogation under existing legislation but actual recovery is very low. However, this is undoubtedly partly because actual recovery is very low in company liquidations, and the Fund's board likely does not judge the effort worthwhile. Recovery would certainly be higher in proposed rescues under provisional supervision. The Fund's board is apparently also concerned that such an expansion would create incentives for abuse of the Fund by unscrupulous employers.[11] However, "[a]s far as unscrupulous employers are concerned, the Labour Department already has the ability to prosecute employers who take advantage of their employees' labour when they are aware that there is no reasonable prospect of the employees being paid their wages as they become due."[12]

Several Symposium participants recommended that the Legislative Council consider establishing a different fund to cover employment claims in provisional supervision. Such a fund could be granted the right of subrogation against the debtor in the case of a successful restructuring, and against the PWIF if restructuring fails and liquidation ensues. Such a right of subrogation should allay the concerns that the fund would be rapidly depleted and that it would be "subsidizing a failing company" – in one Symposium participant's words – any more than the PWIF currently subsidizes a failed company. Funding, whether by the PWIF or a new fund, would only be granted on commencement of provisional supervision. Some Symposium participants suggested that the new fund, unlike the PWIF, not rely solely on the business community for its source of funding.

Alternate E - Private Funding of Employment Claims

Restructuring often fails to rescue a company but may nonetheless provide for a better return on creditor claims than a straightforward winding up of the company. This is clearly the case if the company fails during poor economic times, when there might be lower-than-normal demand for its assets. As already stated above, requiring payment of employment arrears upon or soon after commencement of restructuring creates an obstacle to the debtor's obtaining the new funding required to restructure. Any party that provided funding to satisfy the employment arrears would face a loss if reorganization failed. One proposal from the Symposium was to allow the party that provided funding

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HK$220,000 per person. Upfront payment by the PWIF would arguably save more jobs than the alternatives.

[11] This concern might be unfounded, as one participant noted that the Official Receiver's records show bankruptcy fraud in far less than 1% of the cases.

[12] Smart & Booth, *supra n.* 1, at p. 195 (citing s. 31 of the Employment Ordinance)..

for the employment claims to have a right of subrogation against the PWIF should the restructuring fail. Such a right should enhance the possibility of obtaining new funding.

Summary of Recommendations for the Treatment of Employees' Outstanding Entitlements

In our view, Alternative D – expanding the role of the PWIF (or creating a new fund) to extend to satisfying employment claims in provisional supervision cases – remains the best solution for addressing workers' claims in provisional supervision and for creating harmony and consistency in Hong Kong's insolvency procedures. However, if it is not politically feasible for this approach to be adopted, then we would recommend adoption of Alternative B, with its 45-day moratorium on the payment of employee claims, as modified by Alternative C to the extent necessary to garner political support.

The inability to reach consensus on these difficult issues regarding the treatment of employees' outstanding entitlements has led to the law reform process being scuttled twice before. In American baseball jargon, "three strikes and you're out"; in our view the same will most likely prove to be the case with provisional supervision. If consensus on workers' entitlements cannot be reached during the current round of consultation, the most likely scenario is that the government will have to abandon the provisional supervision approach and start afresh. It is our sincere hope that it does not come to that, as much thoughtful and excellent work has been put into formulating a workable provisional supervision approach, as evidenced by the FSTB's *Consultation Paper*, the Symposium, and subsequent written submissions in response to the *Consultation Paper*.

(2) Enactment of a modified, hybrid debtor-in-possession approach

We would also like to take this opportunity to discuss the merits of introducing a modified, hybrid DIP option, which Professor Booth initially proposed at the Symposium. We realize that the term DIP is a charged one and in the past has led to emotional responses in Hong Kong that Hong Kong law would be "Americanized" and become too debtor friendly. The FSTB repeated similar sentiments in para. 1.6 of the *Consultation Paper,* at p. 7:

> "[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."[13]

We were well aware of these concerns when Professor Booth floated the idea at the Symposium. We wish to reiterate that our DIP proposal is **not** the transplantation of the American DIP approach, but rather is a hybrid model that incorporates a DIP option into the proposed provisional supervision procedure. Our proposal will improve the existing provisional supervision procedure, make it more attractive to a broad variety of debtors in Hong Kong, will better protect the interests of creditors, and is quite likely to increase the chances of success when companies pursue provisional supervision.

Under our hybrid approach, there will be two mechanisms in place to ensure that management does not avoid or delay repayment of its obligations to creditors. Firstly, when a provisional supervision is commenced, corporate management may request permission to be allowed to continue in position as DIP. Permission is to be granted by a vote of the creditors (for example, the requirement could be approval by the majority of creditors in amount and including the three largest creditors). Thus, management will only be allowed to carry on in position in those instances where it has the support of major creditors. Secondly, in all cases of provisional supervision a provisional supervisor will be appointed to protect the interests of creditors.

The Proposed Options

Although we envision that a DIP mechanism will be quite useful to have in place, we do not believe that it is a panacea and realize that it will not be appropriate in all cases – it will be an alternative form, not the sole form, of restructuring. With the enactment of a hybrid DIP approach, we can envision three potential paths that could be available under provisional supervision:

(1) Where creditors vote in support of management's request for the debtor to carry on as DIP:

(a) Plan A-1: The provisional supervision proceeds with management running the debtor's day-to-day affairs and the provisional supervisor acting in a supervisory capacity.

(b) Plan A-2: The provisional supervision proceeds with management acting in a subordinate capacity under the day-to-day control of the provisional supervisor.

Note: Provisional supervision could include either Plan A-1 or Plan A-2, or (our preference) both Plan A-1 and A-2.

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[13] Emphasis in original.

(2) Where creditors reject management's request for the debtor to carry on as DIP:

(a) Plan B: The provisional supervision proceeds with the provisional supervisor running the day-to-day affairs of the debtor and management is removed.

When the debtor commences provisional supervision or within three days of the commencement of provisional supervision, the debtor's management would be able to make a request to the provisional supervisor for management to remain in position and for the debtor to carry on as DIP. The provisional supervisor would then call a meeting of creditors to discuss and vote upon the debtor's request.[14] In contrast with an out-of-court, consensual workout under the Hong Kong Approach,[15] the hybrid DIP approach contemplates restructuring even in the event there are a few holdouts among the creditors, in which case the other creditors and the debtor would benefit from the moratorium.

It is a premise of the DIP approach that creditors are fit to determine whether management is competent and capable of reviving the company. Giving "veto power" to the creditors helps to align debtor management with the interests of creditors and protects against rewarding incompetent management and risking further losses. The law should set forth clear procedures for instances where creditors do not approve management's DIP request, in which case, depending on the creditors' vote, the company would be restructured under a traditional provisional supervision or liquidated in a compulsory winding up.

We envision that giving the creditors veto power over the debtor's request to continue on as a DIP would lead to early negotiation between management and creditors and, in many cases, a pre-packaged rescue plan, which may be considered a more cost-effective alternative.

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Further Details of Plan A-1 and A-2

Plan A-1

Under Plan A-1, running the debtor's business affairs on a day-to-day basis would be left to management. The provisional supervisor would act in a supervisory capacity, with the power to draw on company assets to employ insolvency practitioners (including

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[14] We propose for the provisional supervisor, rather than the court, to call the meeting because we are trying to minimize the court involvement in the procedure, so as to save costs and to expedite the process. Only in contested cases involving dispute would recourse have to be made to court.

[15] See para.1.2 of the *Consultation Paper*.

attorneys and accountants) to audit or examine the company and its management at any time during the provisional supervision process. Should the provisional supervisor find that the debtor's assets are being wasted or used other than for the benefit of creditors, or determine the existence of other conflicts of interest or improprieties, the provisional supervisor could apply to the court to have management removed and have the provisional supervision continue under Plan-B in the form envisioned in the *Consultation Paper*. As a safeguard against waste and self-enrichment, personal liability for insolvent trading would stay with the management under Plan A-1.

Under Plan A-1, the provisional supervisor and management would work together in formulating the rescue plan in the form of a voluntary arrangement proposal to be put to creditors for their vote.

<u>Plan A-2</u>

Under Plan A-2, the provisional supervisor would take control of the company as is contemplated for provisional supervision. However, rather than being displaced, management would be retained in a subordinate capacity, to advise and assist with the restructuring. It would be up to the provisional supervisor to determine the continuing role of management, if any, in regard to the formulation of a voluntary arrangement proposal. Under Plan A-2, personal liability for insolvent trading would shift to the provisional supervisor after initiation of the provisional supervision.

Benefits of a DIP Approach

Clearly, it is possible to conform the DIP approach to other political and economic considerations. We mean here simply to set forth in writing the two alternatives that arose in discussions during the Symposium.

We were heartened at much of the initial support shown at the Symposium in favor of a hybrid DIP procedure.

A DIP option makes reorganization a more viable alternative in many cases for a variety of reasons, including the following: (i) it incentivizes management to begin restructuring earlier; (ii) it makes reorganization more acceptable to family-run businesses and Small-to-Medium Sized Enterprises (SMEs); (iii) it leverages the advantages of effective management such as industry knowledge and personal connections; (iv) it encourages pre-packaged rescues; and (v) it may enhance cross-border co-operation in restructuring (especially with mainland China);

A DIP Option Can Lead Management to Commence Restructuring Earlier

Clearly, the more assets and fewer arrears a debtor has, the better prospects the debtor company will have at a successful restructuring – as it will have less debt to restructure, more assets with which continue and grow its business, and a better balance sheet with which to entice new creditors and business partners. Where provisional supervision requires the firing of management – regardless of the circumstances of the insolvency or the confidence creditors have in existing management[16] – the interests of management and of the company's other stakeholders tend to diverge as a company becomes more distressed.

Where the corporate rescue procedures require the firing of management, there is little incentive for management to seek provisional supervision early, as it would mean losing their jobs earlier. Indeed, mandatory replacement of management on insolvency actually motivates management to hide a distressed company's financial status from its creditors and further deplete assets and accumulate debt in increasingly desperate attempts to salvage the company and their jobs.[17] A DIP regime enhances the probability of a successful restructuring because it overcomes management hesitancy and resistance to reorganization and incentivizes management to "come clean" and negotiate with creditors at an earlier stage, when the business has more assets and fewer arrears.

Even where liquidation is ultimately chosen, early action by management often results in greater satisfaction of debts than would otherwise be the case. Thus, a DIP approach makes the restructuring process less threatening to management, involves creditors earlier, and thereby enhances the prospect of a successful restructuring or greater satisfaction of debts on liquidation. The creditors would explicitly be in accord with management, as they would grant their required approval only if they were satisfied with management's ability to carry out a successful restructuring.

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[16] Insolvency is often caused by factors outside management control, such as factors that reduce the availability of working capital (*e.g.*, trouble in the credit markets), that suddenly raise the cost of inputs (*e.g.*, speculation in the oil futures markets), or that cause a temporary but drastic reduction in demand (*e.g.*, an epidemic, acts of terror or sudden changes in equity or debt markets, that reduce consumer confidence). At other times, management's behaviour or decisions are a factor, and new management is brought in that might with time determine that restructuring is in the company's best interest. In such circumstances, punitive treatment of management in restructuring makes little sense.

[17] It is intuitive (and studies suggest) that the farther a company's performance falls below what management considers normal or acceptable the more risk-prone management is in its attempts to normalize operations.

A DIP Option Makes Restructuring an Especially Attractive Alternative to Distressed Family-Run Enterprises and SMEs

For Hong Kong, as for much of the region, the largest foreseeable need for a corporate restructuring regime is for SMEs, often controlled and managed by a family. Family-run enterprises, whether SMEs or larger, have historically been opposed to a corporate restructuring regime that has no place for the continued participation of existing management and that further burdens the distressed business with the cost of hiring insolvency professionals. The FSTB notes in para. 1.12 of the *Consultation Paper*, at p. 9, that:

> "SMEs may be relatively less likely to benefit from such a procedure [provisional supervision] 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."

A son or grandson of the corporate founder is understandably going to be reluctant to commence provisional supervision not only because he would fear that the other family members and he himself would lose their jobs, but also for reasons of personal shame in having to take responsibility for the family failure.

To win support among family-run enterprises, the legislative proposal should provide a way for families to stay involved with the company undergoing restructuring. A regime that offers the hybrid DIP alternative stands the best chance of attracting support of, and compliance by, family-run enterprises and SMEs. Moreover, in Hong Kong, many large, and listed, corporate enterprises are family controlled, and the enactment of a hybrid DIP option would also facilitate the rescue of such businesses.

Management Is Not Always Fully Replaceable

In many cases, the displacement of long-term management will severely handicap the debtor's reorganizing. As compared to a provisional supervisor, existing management will generally have more thorough knowledge of the relevant industry as well as irreplaceable familiarity with the company itself. Such knowledge may be of significant utility in restructuring the company. In addition, in family-run enterprises, the goodwill of the company is often tied up in the family's connections and dealings with creditors, business partners and customers. Allowing for a DIP approach would keep the goodwill with the restructuring company for the benefit of the creditors. It should perhaps not be surprising that when outside managers are brought in and existing management is released, the rescue often takes the form of a sale of assets or businesses. Retaining existing management can thus increase the prospects that the business survives intact (when there are solid financial reasons for doing so) – and jobs thereby retained – or increase the distribution to creditors on winding up.

A DIP Approach Encourages Pre-Packaged Rescues

As noted above, the DIP approach incentivizes management to begin working with creditors earlier than would otherwise normally occur. One benefit of such collaboration is that the various interested parties can negotiate and formulate the voluntary arrangement proposal prior to commencing provisional supervision, which they could present to creditors shortly after the commencement of provisional supervision. Such a "pre-packaged rescue" would greatly reduce the expense of provisional supervision for all interested parties, including (importantly) employees.

A DIP Approach May Enhance Cross-border Co-operation in Restructuring

Almost every corporate insolvency in Hong Kong has cross-border aspects, especially with mainland China. The difficulties in gaining recognition of Hong Kong insolvencies in China are well known.[18] Interestingly, there is some support for the contention that the mainland is more likely to provide recognition to liquidators from Hong Kong appointed in voluntary liquidations commenced by company directors or shareholders than to liquidators appointed in court-controlled compulsory liquidations – this result arises from a misconception by some in the mainland that liquidators appointed "voluntarily" by a company have the endorsement of the company's shareholders and directors, but that liquidators appointed "involuntary" are being appointed against the wishes of a company's shareholders and directors.[19]

This contention might seem to be counterintuitive to many Hong Kong insolvency professionals – and certainly the reasoning is troublesome. Nevertheless, there is no denying that it is often difficult for Hong Kong liquidators to gain the co-operation of parties in the mainland when it is clear that disagreements have arisen between liquidators appointed in a compulsory liquidation and the directors of the company. An accomplished insolvency practitioner reported at the Symposium that a provisional supervisor is much more likely to secure cooperation from relevant parties in mainland China (officials, creditors, factory managers, *et al.*) if he is introduced by the manager whom they know and with whom they have previously dealt.

Moreover, adoption of the hybrid DIP approach as proposed here would create more symmetry with the corporate rescue procedures recently enacted in mainland China, which would be helpful given the extent of cross-border operations of many Hong Kong-based companies. China has recently enacted its own version of a hybrid DIP procedure.

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[18] *See* Charles Booth, *Drafting Bankruptcy Laws in Socialist Market Economies: Recent Developments in China and Vietnam,* 18 COLUMBIA JOURNAL OF ASIAN LAW 93, 142-143 (2004); Xianchu Zhang & Charles D. Booth, *Beijing's Initiative on Cross-Border Insolvency: Reflections on a Recent Visit of Hong Kong Professionals to Beijing,* 31 HONG KONG LAW JOURNAL 312, 317-320 (2001).

[19] *See* Zhang & Booth, *supra* n. 18, at p. 320.

Pursuant to article 73 of the PRC Enterprise Bankruptcy Law, which was enacted on 27 August 2006 and came into effect on 1 June 2007 (the 2006 PRC Enterprise Bankruptcy Law), the debtor may apply to the People's Court for approval to manage its assets and business affairs by itself under the supervision of an administrator (a new functionary created as part of the reformed reorganization procedure). Where the court grants approval, an administrator who has already taken control of the debtor's property and business affairs must return control to the debtor.[20] From that day forward, the debtor exercises the administrator's powers and functions.

Article 73 of the 2006 PRC Enterprise Law thus corresponds to our proposed Plan A-1. Article 74 of the PRC law, in turn, provides that an administrator who has taken charge of a debtor's assets and business operations may employ the debtor's business managers to take care of the business operations. Article 74 is thus analogous to our Plan A-2. A weakness of the Chinese law is that it neither sets forth criteria for the court to use in determining a request by management to remain in possession nor clarifies the procedure to be followed if a debtor's creditors object to the appointment. We have tried to avoid these problems by giving the creditors the right to vote on whether a debtor should continue on as DIP.

Summary of recommendations for the enactment of a hybrid DIP approach

We hope that the FSTB and the Hong Kong Government gives serious consideration to incorporating a hybrid DIP option into provisional supervision. Ideally, we would suggest incorporating both Plan A-1 and Plan A-2. The incorporation of such a versatile mechanism would greatly improve the overall success of a provisional supervision procedure.

We realize that our proposal comes late in the consultation process. We are also aware of the FSTB's comments in para. 1.9 of the *Consultation Paper*, at pp. 8-9, that "explor[ing] other fundamentally different approaches … will deviate from the consensus already achieved during the earlier legislative attempts and unduly delay the introduction of a corporate rescue procedure in Hong Kong." In response, we respectfully note that the consensus as to the earlier attempts to promulgate provisional supervision was generally negative – which is why we now find ourselves in the midst of a third version of the provisional supervision proposals, and which is precisely why we think the time is ripe to introduce alternatives that that we believe will garner greater support for provisional supervision. That being said, we realize that it might prove politically difficult at this stage to incorporate a hybrid DIP approach into proposed legislation without conducting public consultation on the proposal and that there might not be time for such consultation. If that is the case, we would hope that this proposal at least be floated among interested parties if not more broadly among the general population to see if there is support. It is our view that as written – without a hybrid DIP approach – provisional supervision will

[20] 2006 PRC Enterprise Bankruptcy Law, art. 73.

prove quite unpopular for both SMEs and larger, family-run companies. Later enactment of a hybrid DIP through amendment would be better than no enactment at all.

We also hope that the FSTB and the Hong Kong Government appreciate that at present Hong Kong has the best insolvency practitioners in Asia, but arguably the worst corporate rescue law. If Hong Kong could enact an effective corporate rescue law that incorporated the best of international practice, Hong Kong's new law could conceivably serve as a model throughout Asia and become the standard by which to measure the effectiveness of restructuring in Asia.

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We are grateful for the opportunity to offer our comments and suggestions on the prospective corporate rescue legislation and look forward to continuing our dialogue. We are happy to provide further information. If you have any questions, please do not hesitate to contact either of us.

Yours sincerely,

<u>Charles D. Booth</u>
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