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Mr. John C.Y. Leung
Financial Services and The Treasury Bureau
Hong Kong SAR
15th Floor, Queensway Government Offices,
66 Queensway,
Hong Kong

27 January 2010

Dear John,

Consultation on
"Review of Corporate Rescue Procedure Legislative Proposals"

Thanks for sending me the captioned document.

Enclosed kindly find a short note on my views of the various reform proposals for your reference and consideration.

If there is anything that I can be of assistance, please kindly let me know.

Yours Sincerely,

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Comments on Review of Corporate Rescue Procedure Legislative Proposals ("Review")

1. In principle, the introduction of a corporate rescue procedure called "provisional supervision" is to be welcomed. The present regime identified in Para.1 of the Executive Summary cannot cater for the needs of Hong Kong's economic development.

2. **First**, it is submitted that the new legislation has to be very alert in preventing ***abuse*** of the initiation of "provisional supervision". At present, there are cases where for fear of being put into liquidation by unfriendly creditors, companies apply to court to appoint provisional liquidators themselves in order to "hold the ring" so to speak.

3. There are considerable benefits to companies (and similarly considerable detriments to creditors in having their contractual rights suspended) by the operation of a moratorium on legal actions that could be and would be brought against a company. The new legislation must ensure that this statutory benefit is not abused.

4. Hence, it is proposed that before there can be an initiation of the "provisional supervision", an application, albeit on *ex parte*, must be made to the court and the court must be satisfied on the evidence that the relevant company is capable of being rescued and the company has a viable plan to rescue the company.

5. For such purpose, the applicant must fully disclose its true and accurate financial position and submit a viable rescue proposal for the court's consideration. The moratorium will only be granted if the court is satisfied that the company is capable of being rescued and there is a *prima facie* viable rescue proposal.

6. The key philosophy is that the law shall not allow companies which obviously are not capable of being rescued from going through the "provisional supervision" when under such situation it will inevitably cause great detriments to the general body of creditors. In such situation, it is in the interest of all creditors and sensible use of economic resources of the society that such companies be put into liquidation as soon as possible so that there will not be any wastage of assets with the creation of unnecessary professional fees.

7. If the initiation of the provisional supervision is left in the hands of the company or its directors or provisional liquidators without the supervision of the court, there is a danger that such procedure will be subject to serious abuses. It is submitted that this aspect of the reform merits further consideration. (In particular, Para.2.4 of the Review)

8. **Secondly**, the orderly realization of the assets of companies which are not capable of being rescued is another interesting topic. An orderly realization of assets is beneficial to the general body of creditors whether the company in question is capable of being rescued or not.

9. **Thirdly**, before the moratorium can ever begin, it must be incumbent upon the applicant to secure the in principle support of its majority creditors. At present, it is suggested that the moratorium will begin and then if a major secured creditor objects to provisional supervision, moratorium and provisional supervision immediately ends.

10. The latter arrangement may not be entirely satisfactory as by then legal costs will have been incurred and some very legitimate claims (some of which may have limitation period issue) will have been stalled. But then the whole process of provisional supervision and moratorium will have to end because of the objection of a majority secured creditor.

11. An applicant is perfectly capable of engaging its major secured creditors to see if they support an application of provisional supervision. If the answer is not, then there is no logic that the applicant should be allowed to kick start the provisional supervision and to have the benefit of the moratorium.

12. **Fourthly**, it is not quite clear as to why a **secured** creditor has such a veto power. Presumably, their interests are covered by the security they have any way.

13. The proposals in relation to the procedures and timeframe of the moratorium are sensible.

14. **Fifthly**, on the treatment of employees' outstanding entitlements, first, trade unions must make to realize that if the companies were to be put into liquidation, there is no possibility that they could have recovered their arrear entitlements in full. At present, many schemes under s.166 of the Companies Ordinance, Cap.32 provides that preferential creditors, like employees will be paid in full **in relation to their statutory entitlements**. That normally covers the amount they can claim under PWIF.

15. Secondly, in my view, there are three principles involved:-

(1) Minimum entitlement principle – employees should be entitled to what is their minimum entitlement under the present legislative regime if the relevant company were to go into liquidation.

(2) Fairness principle – Employees' outstanding claims, other than the

statutorily protected portion, should in principle be treated as other unsecured creditors. They should have their voting rights and entitlement to distribution as other unsecured creditors like suppliers, bankers who all contributed to the operations and survival of the relevant company.

(3) Employees as **assets** of the company principle – Traditionally, employees' outstanding claims are treated liabilities of a company (at least in accounting sense), but in most cases employees are really the most important asset of the company (though this is not reflected in the financial statements of the company). Whoever takes up the company after the operation of a rescue plan, they normally also takes up the employees, so in all fairness, the new investor shall pay for the outstanding claims of the employees. It is likely they are acquiring an asset of the company. This also has a great stabilizing effect to the general economy and society as a whole.

16. Theoretically, I am inclined to support Alternative B as proposed. It makes no sense to exempt employees who are owed wages or other entitlements from the moratorium as they can petition to court to wind up the company in question which defeats the whole purpose of corporate rescue.

17. Having analyzed the options in the above manner, I am obliged to point out that although one is inclined to support an option that will grant full payment to employees albeit within 12 months, the reality of the situation is that if Alternative B is implemented, investors or white knights will simply ***buy out all the assets of the company at a certain price*** instead of taking over the company as a whole. They will then offer new contracts to the existing employees. This has already happened, for example, in the Lehman Brothers' liquidation and in some of the cases that I have handled.

18. The disincentive created by adopting Alternative B will put more companies into liquidation and for "white knights" to simply pick up assets of the liquidated company at a bargain. There is nothing to prevent commercial entities from preferring to see companies to go into liquidation and then to pick up its assets rather than to participate in a corporate rescue for the benefit of employees. This is yet another example of good intention bring about bad results.

19. Hence, I am of the view that both Alternative A and Alterative B are not ideal and not constructive to corporate rescue. To be pragmatic, one must realize that to insist on full payment to employees' outstanding claims may not be beneficial both to the underlying objective of corporate rescue and the interest of employees.

20. In the circumstances, I propose that, in order to encourage corporate rescue, the employees' outstanding claims other than the preferential part should be counted as ordinary unsecured debts to be voted in the same class as other unsecured creditors.

21. As a sweetener to employees' participation in corporate rescue, though it could strongly be argued that their claims should be no different from unpaid suppliers (one supplies materials, one supplies labour), the employees' outstanding claims can be given greater weight. For instances, the employees' claims count as double in both voting and distribution of assets. This is an area that merits further exploration and deliberation.

22. **Sixthly**, as far as the qualification of provisional supervisors is concerned, ***it is high time that this should be regulated***. Presently, there is no established professional qualification or licensing system for professionals engaged in such operations. So accountants with no or little experience in liquidation, solicitors with no accounting or financial knowledge, are both allowed to practice as provisional liquidators. This

has generated unnecessary costs and very costly liquidation. This has also created great frustration and unfairness to users of our legal system.

23. It is also a real concern in the industry that the high costs of provisional liquidation has deterred companies from resorting to the appointment of provisional liquidators. This has everything to do with both sub-standard services provided by the present provisional liquidators and the unregulated charges that they are allowed to charge the users of our legal system. the qualification and costs of provisional liquidators.

24. It is not difficult at all to establish an accreditation system on insolvency practice. Presently, there is a diploma course on insolvency for accountants. I am strongly of the view that if the corporate rescue regime is going to work, there must be a pool of competent professionals to handle provisional supervision. This will also increase the professional image of Hong Kong as a financial centre.

25. Hence, I propose that there should have an accreditation course and status to be regulated by an independent board comprising accountants, solicitors or other professionals. The details of such accreditation can be worked out subsequently.

26. **Seventhly**, I strongly support the idea that the creditors be given the choice to replace the provisional supervisor and to approve their remuneration. One must bear in mind that when companies are insolvent, the one who controls the company owes a fiduciary duty to its creditors. So there is no reason why creditors should not have a say on the choice of provisional supervisor and their remuneration.

27. **Eighthly**, I agree with the imposition of personal liability on provisional supervisors as proposed in Paras. 5.14 to 5.17 of the Review. It makes

perfect sense.

28. **Ninthly**, it is high time that insolvent trading be introduced. My answers to Q15 and Q16 are in the affirmative.

29. **Tenthly**, the headcount test should be abolished once and for all. It serves no useful purpose at all. It is perfectly open to creditors to assign their debts to various individuals for the purpose of voting. There could be no prohibition of assignment of debts.

Dated this 28th day of January 2010

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