Review of Corporate Rescue Procedure Legislative Proposals

Consultation Paper

Financial Services and
the Treasury Bureau

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ABOUT THIS DOCUMENT

1. This paper is published by the Financial Services and the Treasury Bureau ("FSTB") to consult the public on the conceptual framework and key issues relating to corporate rescue.

2. After considering the views and comments, we aim to issue the consultation conclusions in mid-2010, with a view to introducing the legislative proposals, on the basis of consensus reached, into the Legislative Council ("LegCo") in 2010 - 11.

3. A list of questions for consultation is set out for ease of reference after Chapter 8. Please send your comments to us on or before **28 January 2010**, by one of the following means:

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

   By fax to: (852) 2869 4195

   By email to: corporate_rescue@fstb.gov.hk

4. Any questions about this document may be addressed to Mr WONG Wing-hang, Assistant Secretary for Financial Services and the Treasury (Financial Services), who can be reached at (852) 2867 5465 (phone), (852) 2869 4195 (fax), or whwong@fstb.gov.hk (email).

5. This consultation paper is also available on the FSTB's website http://www.fstb.gov.hk/fsb and the website of the Official Receiver's Office ("ORO") http://www.oro.gov.hk.

6. Submissions will be received on the basis that we may freely reproduce and publish them, in whole or in part, in any form and use, adapt or develop any proposal put forward without seeking permission or providing acknowledgment of the party making the proposal.

7. Please note that names of respondents, their affiliation(s) and comments may be posted on the FSTB's website or referred to in other documents we publish. If you do not wish your name and/or affiliation to be disclosed, please state so when making your submission. Any personal data submitted will only be used for purposes which are directly related to consultation purposes under this consultation paper. Such data may be

transferred to other Government departments/agencies for the same purposes. For access to or correction of personal data contained in your submission, please contact Mr WONG Wing-hang (see paragraph 4 above for contact details).

ACKNOWLEDGEMENT

In formulating the proposals for consultation, we have benefited from the advice of the Standing Committee on Company Law Reform, and informal advice of stakeholders from the legal, insolvency, labour, business, banking and academic sectors. We would like to extend our sincere thanks to them for sharing their preliminary views with us.

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ABBREVIATIONS

1996 Report	LRC's Report on Corporate Rescue and Insolvent Trading (1996)*
2001 Bill	Companies (Corporate Rescue) Bill 2001**
CO	Companies Ordinance (Cap 32)
EO	Employment Ordinance (Cap 57)
FSTB	Financial Services and the Treasury Bureau
LegCo	Legislative Council
LRC	Law Reform Commission of Hong Kong
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MPFSO	Mandatory Provident Fund Schemes Ordinance (Cap 485)
OR	Official Receiver
ORO	Official Receiver's Office
ORSO	Occupational Retirement Schemes Ordinance (Cap 426)
PWIF	Protection of Wages on Insolvency Fund
SFO	Securities and Futures Ordinance (Cap 571)
SMEs	Small and Medium Enterprises
UK	United Kingdom
US	United States

* Available at http://www.hkreform.gov.hk/en/publications/rrescue.htm
** Available at http://www.legco.gov.hk/yr00-01/english/bills/c025-e.pdf

EXECUTIVE SUMMARY

1. At present, Hong Kong companies that are in financial difficulty have various options for going forward, such as:

   (a) coming to a **non-statutory arrangement** with their creditors;

   (b) coming to a compromise or arrangement under **section 166** of the CO; or

   (c) effecting a corporate restructuring by a provisional liquidator appointed under **section 193** of the CO in the course of **winding up**.

   However, each of the above options has its own drawbacks. Therefore, there is a need to introduce a corporate rescue procedure to bridge the gap.

2. The LRC recommended in 1996, in its Report on Corporate Rescue and Insolvent Trading, the introduction of a corporate rescue procedure called "provisional supervision" whereby a moratorium on legal action would be provided to a company in financial difficulty. Bills were previously introduced into the LegCo twice in 2000 and 2001 to implement LRC's recommendations, but due to the complexity of the legislative proposals and the diverse views among stakeholders, the proposals were not enacted.

3. As part of the response to the recent global financial crisis, the Government has adopted the recommendation made by the Task Force on Economic Challenges in late January 2009 to re-consider the introduction of a corporate rescue procedure to facilitate companies with viable long-term business prospects, but in short term financial difficulty, to turn around or restructure.

4. We consider that it would be the most beneficial and expedient approach to make use of the 2001 Bill as the basis for the review. The recent global financial crisis has once again highlighted the need to consider the introduction of provisional supervision as a corporate rescue procedure in Hong Kong. The 2001 Bill serves as a useful starting point for us to revisit our initiative by building on the consensus already reached during the earlier legislative attempts and resolving the concerns raised.

5. We believe that the following objectives for provisional supervision remain valid:

   (a) The survival of the company, and the whole or any part of its undertaking, as a going concern;

(b) A more advantageous realisation of the company's property than would be effected on a winding up of the company; and

(c) The more advantageous satisfaction, in whole or in part, of the debts and other liabilities of the company.

6. In the review, we have taken into account the following principles:

(a) Provisional supervision should complement, and not replace, existing restructuring arrangements under the CO and non-statutory arrangements (such as voluntary workouts under the Hong Kong Approach to Corporate Difficulties);

(b) Court involvement should be minimised so as to save costs and time;

(c) Employees should generally be no worse off than in the case of insolvent liquidation; and

(d) Consideration should be given to allowing greater involvement of creditors in the rescue process in exchange for their being bound by the moratorium once the process commences and the rescue plan is agreed.

7. The present consultation covers the following issues:

(a) Initiation of provisional supervision *(Chapter 2)*;

(b) Moratorium *(Chapter 3);*

(c) Employees' outstanding entitlements *(Chapter 4);*

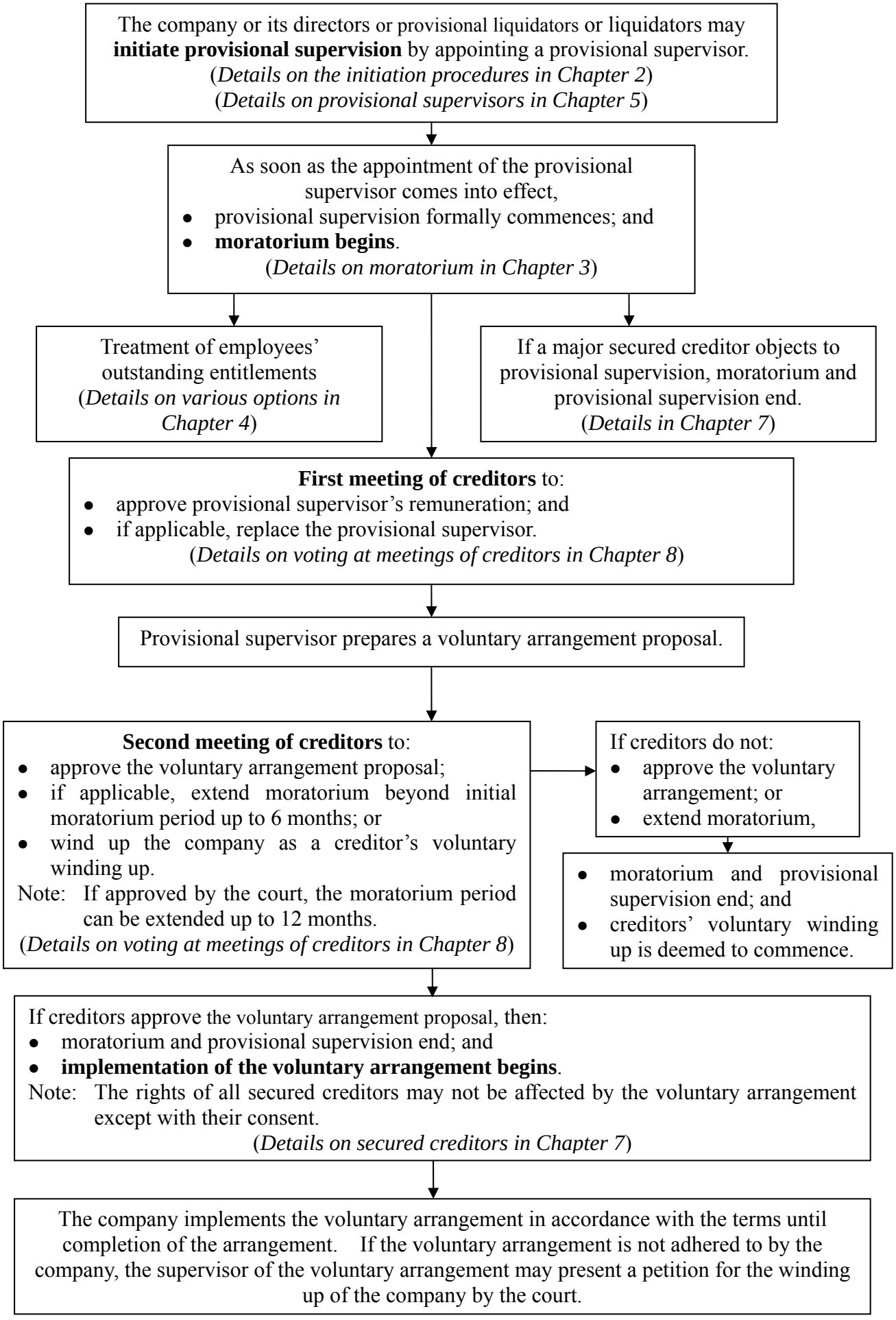
(d) Provisional supervisor *(Chapter 5);*

(e) Insolvent trading *(Chapter 6)*;

(f) Secured creditors *(Chapter 7)*; and

(g) Voting at meetings of creditors *(Chapter 8)*.

8. To facilitate understanding the proposed operation of provisional supervision, a diagrammatic illustration is provided on the next page for reference:


The company or its directors or provisional liquidators or liquidators may **initiate provisional supervision** by appointing a provisional supervisor.
(*Details on the initiation procedures in Chapter 2*)
(*Details on provisional supervisors in Chapter 5*)
As soon as the appointment of the provisional supervisor comes into effect,
• provisional supervision formally commences; and
• **moratorium begins**.
(*Details on moratorium in Chapter 3*)
Treatment of employees' outstanding entitlements
(*Details on various options in Chapter 4*)
If a major secured creditor objects to provisional supervision, moratorium and provisional supervision end.
(*Details in Chapter 7*)
First meeting of creditors to:
• approve provisional supervisor's remuneration; and
• if applicable, replace the provisional supervisor.
(*Details on voting at meetings of creditors in Chapter 8*)
Provisional supervisor prepares a voluntary arrangement proposal.
Second meeting of creditors to:
• approve the voluntary arrangement proposal;
• if applicable, extend moratorium beyond initial moratorium period up to 6 months; or
• wind up the company as a creditor's voluntary winding up.
Note: If approved by the court, the moratorium period can be extended up to 12 months.
(*Details on voting at meetings of creditors in Chapter 8*)
If creditors do not:
• approve the voluntary arrangement; or
• extend moratorium,
• moratorium and provisional supervision end; and
• creditors' voluntary winding up is deemed to commence.
If creditors approve the voluntary arrangement proposal, then:
• moratorium and provisional supervision end; and
• **implementation of the voluntary arrangement begins**.
Note: The rights of all secured creditors may not be affected by the voluntary arrangement except with their consent.
(*Details on secured creditors in Chapter 7*)
The company implements the voluntary arrangement in accordance with the terms until completion of the arrangement. If the voluntary arrangement is not adhered to by the company, the supervisor of the voluntary arrangement may present a petition for the winding up of the company by the court.

9. The Government will carefully study the comments received during this consultation before taking a final view on the proposals. We plan to issue consultation conclusions in mid-2010 and prepare draft legislation, on the basis of consensus reached, for introduction into LegCo in 2010 - 11.

CHAPTER 1

INTRODUCTION

Background

1.1 At present, Hong Kong companies that are in financial difficulty have various options for going forward, such as:

(a) coming to a **non-statutory arrangement** with their creditors;

(b) coming to a compromise or arrangement under **section 166** of the CO; or

(c) effecting a corporate restructuring by a provisional liquidator appointed under **section 193** of the CO in the course of **winding up**.

However, as explained in paragraphs 1.2 to 1.4 below, each of the above options has its own drawbacks. Therefore, there is a need to introduce a corporate rescue procedure to bridge the gap.

1.2 In pursuing **non-statutory arrangements** with creditors, a well-established route is through voluntary workouts between companies and their bank creditors. Such arrangements often operate in accordance with the "Hong Kong Approach to Corporate Difficulties" ("the Hong Kong Approach"), which are guidelines jointly issued by the Hong Kong Monetary Authority and the Hong Kong Association of Banks in November 1999. Although the Hong Kong Approach has generally been well received, it only applies to banks and not other creditors and its successful implementation depends entirely on voluntary cooperation.

1.3 A company and its creditors may make use of **section 166** of the CO to come to a binding compromise or arrangement. However, the major deficiency of section 166 is the lack of a moratorium which can bind creditors while an arrangement plan is being formulated. As the process can be disrupted at any time if a creditor decides to petition for the company to be wound up, the lack of a moratorium creates uncertainty. There have also been complaints that schemes of arrangement are complex and require too much court involvement.

1.4 In recent years, the court has shown some flexibility, in appropriate cases, in allowing provisional liquidation procedures under **section 193** of the CO to be used to facilitate corporate rescue in the course of a company's **winding**

up.[1] The CO provides that no action or proceeding can be proceeded with or commenced against the company when a winding-up order has been made or a provisional liquidator has been appointed. Under the auspices of a stay of action during the winding up, provisional liquidation provides benefits to parties trying to restructure a debtor company. Nevertheless, there is limitation to such use of provisional liquidation procedures. In *Re Legend International Resorts Ltd.*,[2] the Court of Appeal held that, in principle, provisional liquidators should not be appointed solely for the purpose of enabling a corporate rescue to take place and that the appointment of provisional liquidators should be on the basis that the company was insolvent and the company's assets were in jeopardy.

1.5 The LRC recommended in 1996, in its Report on Corporate Rescue and Insolvent Trading, the introduction of a corporate rescue procedure called "provisional supervision" whereby a moratorium on legal action would be provided to a company in financial difficulty.[3] The LRC 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. In addition, to encourage directors and senior management to act on insolvency earlier rather than later, the LRC also recommended that directors and senior management be made personally liable for debts of a company which traded while insolvent. Provisional supervision would have assisted companies in financial difficulty to turn around and continue to operate as going concerns.

1.6 The 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"[4] 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. In addition, we are mindful that the Chapter 11 regime requires heavy court involvement, which is costly and time-consuming. The regime proposed by LRC relied less on

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[1] Since *Re Keview Technology (BVI) Ltd* [2002] 2 HKLRD 290, the court has been willing, in appropriate cases, to give a provisional liquidator appointed under section 193 of the CO power to seek to effect a corporate restructuring.

[2] [2006] 2 HKLRD 192.

[3] The LRC report is available at http://www.hkreform.gov.hk/en/publications/rrescue.htm.

[4] By successfully invoking Chapter 11, a debtor in the US who intends to reorganise its business is permitted to continue to operate its business as a "debtor in possession" under the protection of the court. The debtor will seek to down-size or close non-viable operations, effect changes in management, etc. and to negotiate with creditors to repay part of their debts and create a business entity as a going concern.

the court.

1.7 Bills were previously introduced into the LegCo twice in 2000 and 2001 to implement LRC's recommendations, but due to the complexity of the legislative proposals and the diverse views among stakeholders, particularly on how to deal with employees' outstanding entitlements, the proposals were not enacted.[5]

1.8 The corporate rescue and insolvent trading proposals were originally scheduled to be reviewed as part of the second phase of the rewrite of the CO.[6] With the onset of the recent global financial crisis and the likely increase in companies facing financial difficulty, the need for the introduction of a corporate rescue procedure has become more pressing. In late January 2009, the Government adopted the recommendation made by the Task Force on Economic Challenges to advance its review of the introduction of a corporate rescue procedure. The FSTB, in conjunction with the ORO, have critically re-examined the provisional supervision framework in the 2001 Bill and the responses as well as the revised proposals with respect to employees' outstanding entitlements put forward by the Government in 2003,[7] with a view to drawing up workable proposals and options for public consultation.

The Review

1.9 Having critically reviewed past proposals and sounded out some of the stakeholders, we consider that it would be the most beneficial and expedient approach to make use of the 2001 Bill as the basis for our review. The recent global financial crisis has once again highlighted the need to consider the introduction of provisional supervision as a corporate rescue procedure in Hong Kong. The 2001 Bill serves as a useful starting point for us to revisit our initiative to introduce a corporate rescue procedure by building on the consensus already reached during the earlier legislative attempts and resolving the concerns raised. It would not be desirable for us to reinvent the wheel and explore other fundamentally different approaches, such as

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[5] The LRC's proposals were first introduced as part of the Companies (Amendment) Bill 2000 but were subsequently removed from the Bill because of insufficient time to resolve the complex issues. A slightly modified version of the proposals was introduced as the Companies (Corporate Rescue) Bill 2001. The Bill was allowed to lapse in 2004 as it was not possible to complete the scrutiny of the Bill by the end of the LegCo term. The 2001 Bill is available at http://www.legco.gov.hk/yr00-01/english/bills/c025-e.pdf. Documents of the LegCo Bills Committees set up to scrutinise the Companies (Amendment) Bill 2000 and the 2001 Bill can be found at http://www.legco.gov.hk/yr99-00/english/bc/bc06/general/ebc06.htm and http://www.legco.gov.hk/yr00-01/english/bc/bc12/general/bc12.htm respectively.

[6] The FSTB is undertaking a comprehensive rewrite of the CO. The ongoing first phase deals with core company provisions concerning the formation and operation of companies. The second phase deals with the winding-up provisions and other insolvency-related provisions in the CO.

[7] The Government's revised proposals concerning employees' outstanding entitlements was put forward in September 2003 and presented to LegCo in 2004. The LegCo brief is available at http://www.legco.gov.hk/yr00-01/english/bc/bc12/papers/bc12cb1-2185-1e.pdf. See also paragraph 4.3 below.

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. Nevertheless, we have looked at recent developments of the corporate rescue regimes in comparable jurisdictions, especially Australia, Singapore and the UK, to see if there is any room for leveraging those developments.

1.10 We believe that the following **objectives** for provisional supervision remain valid:

(a) The survival of the company, and the whole or any part of its undertaking, as a going concern;

(b) A more advantageous realisation of the company's property than would be effected on a winding up of the company; and

(c) The more advantageous satisfaction, in whole or in part, of the debts and other liabilities of the company.

1.11 Objective (a) is particularly relevant to the recent global financial crisis. The procedure would be particularly helpful in reducing the stress to the economy when a greater number of companies with viable business for the longer term face more immediate and short term financial difficulty in a cyclical economic downturn. It would be beneficial to the company's shareholders and creditors who might in due course get a better return from the success of the rescue plan than from the outcome of a winding up. It would also be beneficial to the company's employees as well as suppliers and contractors for that portion of employment and purchases that might be retained by the rescue.

1.12 Whether a company can ultimately be rescued depends on a host of factors, in particular, whether it has a longer-term sustainable or viable business model. 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 core business activities, etc.

1.13 In the review, we have taken into account the following **principles**:

(a) Provisional supervision should complement, and not replace, existing restructuring arrangements under the CO and non-statutory arrangements (such as voluntary workouts under the Hong Kong Approach);

(b) Court involvement should be minimised so as to save costs and time;

(c) Employees should generally be no worse off than in the case of insolvent liquidation; and

(d) Consideration should be given to allowing greater involvement of creditors in the rescue process in exchange for their being bound by the moratorium once the process commences and the rescue plan is agreed.

1.14 We would like to invite views on proposals or options for adjustments to the following elements in the 2001 Bill:

(a) Initiation of provisional supervision;

(b) Moratorium;

(c) Employees' outstanding entitlements;

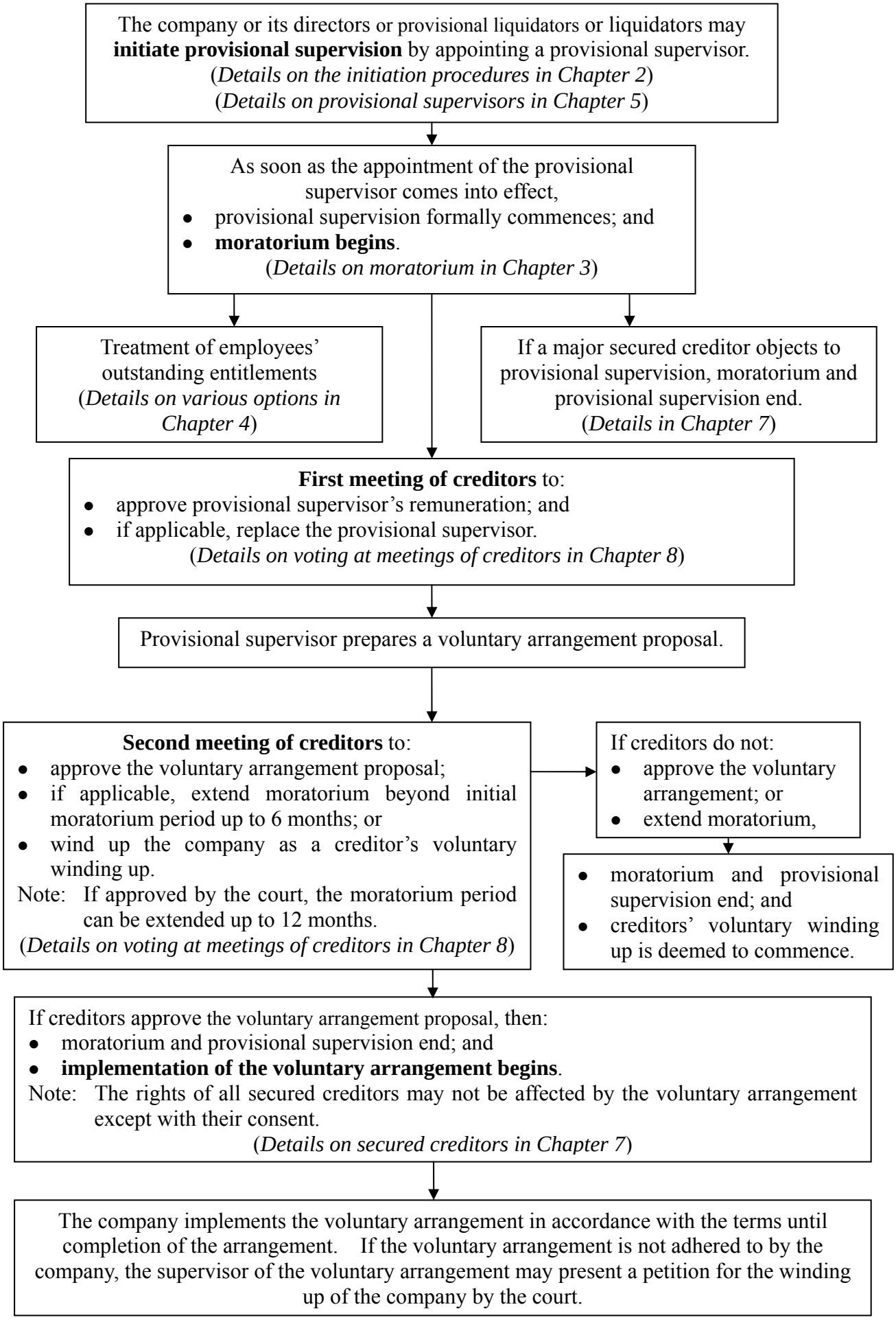
(d) Provisional supervisor;

(e) Insolvent trading;

(f) Secured creditors; and

(g) Voting at meetings of creditors.

1.15 The details are set out in Chapters 2 to 8 below. To enhance the readability of each subject, we will start with a brief background of the relevant issues with particular reference to the 2001 Bill before presenting the proposed changes and/or options. The questions for consultation are set out under different sections in each chapter and a list of all questions for consultation is extracted at the back of the document after Chapter 8. To facilitate understanding the proposed operation of provisional supervision, a diagrammatic illustration is provided on the next page for reference (same as the one on page 4):


The company or its directors or provisional liquidators or liquidators may **initiate provisional supervision** by appointing a provisional supervisor.
(*Details on the initiation procedures in Chapter 2*)
(*Details on provisional supervisors in Chapter 5*)
As soon as the appointment of the provisional supervisor comes into effect,
• provisional supervision formally commences; and
• **moratorium begins**.
(*Details on moratorium in Chapter 3*)
Treatment of employees' outstanding entitlements
(*Details on various options in Chapter 4*)
If a major secured creditor objects to provisional supervision, moratorium and provisional supervision end.
(*Details in Chapter 7*)
First meeting of creditors to:
• approve provisional supervisor's remuneration; and
• if applicable, replace the provisional supervisor.
(*Details on voting at meetings of creditors in Chapter 8*)
Provisional supervisor prepares a voluntary arrangement proposal.
Second meeting of creditors to:
• approve the voluntary arrangement proposal;
• if applicable, extend moratorium beyond initial moratorium period up to 6 months; or
• wind up the company as a creditor's voluntary winding up.
Note: If approved by the court, the moratorium period can be extended up to 12 months.
(*Details on voting at meetings of creditors in Chapter 8*)
If creditors do not:
• approve the voluntary arrangement; or
• extend moratorium,
• moratorium and provisional supervision end; and
• creditors' voluntary winding up is deemed to commence.
If creditors approve the voluntary arrangement proposal, then:
• moratorium and provisional supervision end; and
• **implementation of the voluntary arrangement begins**.
Note: The rights of all secured creditors may not be affected by the voluntary arrangement except with their consent.
(*Details on secured creditors in Chapter 7*)
The company implements the voluntary arrangement in accordance with the terms until completion of the arrangement. If the voluntary arrangement is not adhered to by the company, the supervisor of the voluntary arrangement may present a petition for the winding up of the company by the court.

Next Step

1.16 We would like to invite comments from all stakeholders, including insolvency practitioners, business and professional bodies, labour unions, academics, and other interested parties, on the proposals. The Government will carefully study the comments received before taking a final view on the proposals. We plan to issue the consultation conclusions in mid-2010. Subject to the outcome of the consultation, we plan to prepare the draft legislation for introduction into LegCo in 2010 -11.

CHAPTER 2

INITIATION OF PROVISIONAL SUPERVISION

Background

2.1 Under the 2001 Bill, provisional supervision, which could be initiated by a company or its directors or provisional liquidators or liquidators by appointing a provisional supervisor, would apply to both local and non-Hong Kong companies formed or registered under the CO, except for the following regulated institutions:[8]

(a) authorised institutions within the meaning of the Banking Ordinance (Cap 155);

(b) authorised insurers within the meaning of the Insurance Companies Ordinance (Cap 41); and

(c) certain entities in the securities and futures industries.[9]

2.2 The company had to file a notice of appointment of provisional supervisor, together with specified documents,[10] with the Registrar of Companies, the OR and the High Court before provisional supervision took effect. The notice would set out, among other things, the level of remuneration of the provisional supervisor. Moreover, the provisional supervisor was required to cause a notice of appointment in specified form to be published as soon as is practicable afterwards in the Gazette, one English language newspaper and one Chinese language newspaper circulating generally in Hong Kong. After the commencement of provisional supervision, the provisional supervisor would, as soon as practicable, by notice require a specified person (including an officer or employee of the company or other relevant person) to prepare a statement of affairs of the company within 7 days or

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[8] The LRC recommended that provisional supervision should not apply to industries that were already regulated by statutes and which had provisions for the relevant authority to assume control of the business or oblige a business to act in a certain manner in case the entity has financial difficulty. The industries recommended for the exemption were (i) banking, (ii) insurance and (iii) securities and futures. We agree with this approach.

[9] In the light of the enactment of the SFO in 2003, we intend to review and update the list of entities in the securities and futures industries to which provisional supervision would not apply so as to take into account the developments in securities law since the introduction of the 2001 Bill. We intend to specify that provisional supervision would not apply to the following entities in the securities and futures industries:

(a) recognised clearing houses, recognised exchange companies, recognised exchange controllers, recognised investor compensation companies or licensed corporations within the meaning of Part 1 of Schedule 1 to the SFO; or

(b) persons authorised to provide automated trading services under section 95(2) of the SFO.

[10] The other documents required include a "consent to act" form duly signed by the provisional supervisor and a notice of an affidavit of the relevant directors or members setting out the reasons for the appointment and confirming that the company has dealt with the entitlements owed to its former and existing employees under the EO.

longer, if permitted by the provisional supervisor. The statement of affairs should disclose particulars of the company's property, debts and other liabilities, the names and addressees of its creditors, details of any securities held by its creditors and such other information as the provisional supervisor may reasonably require.

Consideration

2.3 Other than the minor procedural changes proposed in paragraphs 2.4 to 2.6 below, we consider the approach in the 2001 Bill to be generally sound. Some other jurisdictions like the UK, Australia and Singapore allow creditors or major secured creditors to apply for corporate rescue procedure as well. We share the LRC's view that there should be no provision for the procedure to be initiated by creditors because, for the most part, creditors would not have sufficient knowledge of the financial position of a company to make a judgment on whether it was a candidate for provisional supervision.[11] For those major secured creditors who may have knowledge of the company's financial position, in practice, they would be in the position to ask the management to initiate provisional supervision as an alternative to the appointment of a receiver.

Proposals

2.4 To minimise court involvement and to simplify the procedure, we **propose** to require the notice of appointment and documents to be filed with only the Registrar of Companies. The notice and documents will be accessible to the public through Companies Registry's electronic search services. There is no need to file the notice and documents with the OR or the High Court.

2.5 In the interest of protecting the entitlements and rights of any injured employees of the company under the Employees' Compensation Ordinance (Cap 282), we **propose** that a company should confirm before the commencement of provisional supervision that it has in place a valid insurance policy to cover its employee compensation liabilities, including liabilities in respect of any work accidents that happened before the commencement of provisional supervision. The subject of employees' outstanding wages and other entitlements will be considered in Chapter 4 below.

2.6 To enable the provisional supervisor to have early access to essential information about the company, in case provisional supervision is initiated by directors, we **propose** that the statement of affairs of the company should be submitted at the directors' meeting that decides to appoint a provisional

[11] See paragraphs 4.8 and 4.9 of the 1996 Report.

supervisor. The provisional supervisor will have the power to request additional information after the commencement of provisional supervision.

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.

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.

2.7 We believe that creditors and other stakeholders of a company should be informed of the initiation of provisional supervision in a timely manner. While creditors will be informed by the provisional supervisor within a short time (3 working days), additionally a notice of appointment of provisional supervisor will be required to 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 while gazettal of the notice of appointment will be required to be published in the next possible Gazette issued immediately following that date. For listed companies, there are additional requirements under the Listing Rules to make public price sensitive information. Therefore, in only a limited number of situations would a creditor have to rely on newspaper announcements. Nevertheless, we note that creditors and stakeholders outside Hong Kong may not have equal access to Hong Kong newspapers. Therefore, before forming a final view on this issue, we would like to invite views on whether there are better alternatives for informing creditors and other stakeholders of the initiation of provisional supervision in a timely manner.

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.

CHAPTER 3

MORATORIUM

Background

3.1 Under the 2001 Bill, provisional supervision formally commenced as soon as the appointment of the provisional supervisor came into effect. At the same time, the moratorium also started. The initial moratorium period which basically was a timeframe for the provisional supervisor to prepare the voluntary arrangement proposal for the meeting of creditors to vote on the proposal was designated as 30 days. Where the provisional supervisor was unable to complete the proposal before the expiration of the initial moratorium, he might, before that expiration, make an application to the court for an extension of the moratorium. If certain conditions[12] were satisfied, the court might grant the extension. However, the court must not extend the moratorium for any period beyond the period of six months from the commencement of provisional supervision. Any extension beyond six months could be approved by the creditors at a meeting of creditors for such period and on such terms as the meeting thought fit.

3.2 During the moratorium, there would be a stay of all civil proceedings (such as an application to the court to wind up the company, appointment of a receiver of the assets of the company) against the company, and the provisional supervisor would make use of that period to formulate a voluntary arrangement proposal for restructuring the company.

3.3 The actual implementation of the voluntary arrangement proposal itself would fall outside the moratorium period. The moratorium period would come to an end once the creditors passed a resolution to accept the voluntary arrangement proposal at the meeting of creditors. Under the 2001 Bill, there would be no statutory limit on the length of time for implementation of the voluntary arrangement proposal, as long as the proposal (including timing) was agreed by the creditors. Whilst voluntary arrangement was in effect, no creditor bound by the arrangement could commence any legal proceedings, including winding-up proceedings, against the company in accordance with the terms of the proposal. Neither could members or directors of the company pass a resolution for winding up the company. However, where the voluntary arrangement is not being adhered to and

[12] The court must be satisfied that:
(a) the provisional supervisor of the company is and has been acting in good faith and with due diligence in discharging his duties and exercising his powers as the provisional supervisor;
(b) the provisional supervisor of the company will be likely to complete the proposal within the period of the extension; and
(c) the creditors as a whole of the company would not be materially prejudiced by the extension.

implemented by the company in accordance with its terms, the arrangement would cease to have effect, and creditors could petition for winding up or pursue other legal proceedings; the supervisor of voluntary arrangement may also present a petition for the winding up of the company by the court.

3.4 Under the 2001 Bill, certain actions or transactions were exempted from the moratorium:

(a) any inquiry or proceedings arising from certain regulatory actions under the Securities and Futures Commission Ordinance (Cap 24) and Securities (Insider Dealing) Ordinance (Cap 395);[13]

(b) certain financial contracts (for example, currency or interest rate swap agreements, or repurchase or reverse repurchase agreements, etc);[14]

(c) debts and liabilities incurred by the company after the commencement of provisional supervision;[15]

(d) any resumptions by Government pursuant to a Government lease;

(e) a petition under section 168A of the CO (members' remedy in case of unfair prejudice); and

(f) any property held by the company as trustee.

Consideration and Proposals

I. Length of Moratorium

3.5 Our preliminary feedback from the banking sector and insolvency practitioners indicates that 30 days may be too tight. Moreover, with the proposed introduction of a mechanism of a first meeting of creditors for creditors to approve the remuneration of the provisional supervisor and to consider replacing the provisional supervisor if necessary within 10 working

[13] In the light of the enactment of the SFO in 2003, we intend to review and update the list of the regulatory actions that are to be exempted from the moratorium so as to take into account the developments in securities law since the introduction of the 2001 Bill.

[14] These transactions were exempted because these dealings occurred in certain closed markets and imposing a moratorium on such contracts would involve unravelling innumerable other contracts which would cause chaos in the market concerned. Such transactions were subject to certain restrictions as set out in clause 11(5) of the 2001 Bill.

[15] These transactions were exempted so that the company could continue with its normal business during the provisional supervision by maintaining the necessary credit facilities with its business partners. Borrowings made by the company in provisional supervision will receive priority over all existing debts, with certain exceptions. The priority of repayment will be in the following order: fixed charges, fees of provisional liquidator/liquidator appointed before the commencement of provisional supervision, wages and other entitlements of employees accrued since the commencement of provisional supervision, contracts entered into by the provisional supervisor and his own fees.

days from the commencement of provisional supervision (see paragraphs 5.12 and 5.13 below), there is a clear need to extend the initial moratorium period.

3.6 We **propose** that the initial moratorium period should be set at 45 days.[16] While some practitioners may wish to have a longer period of, say, up to 60 days, we have to bear in mind the possible impact on the treatment of employees' outstanding entitlements[17] and other creditors and strike a balance.

Question 4

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

II. Extension of Moratorium

3.7 To minimise court involvement and give creditors greater involvement and control during the provisional supervision process, we **propose** to have any extension of moratorium beyond the initial moratorium period to be approved by the creditors at a meeting of creditors. Any such extension should not exceed a maximum period of six months from the commencement of provisional supervision, to encourage prompt action.[18]

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.

[16] We have made reference to corporate rescue procedures in Australia, Singapore and the UK. The design and objectives of the various schemes vary, and some jurisdictions have more than one type of corporate rescue procedure. For the purpose of comparison, generally speaking, the "initial moratorium" (from commencement of the procedure to the meeting of creditors to vote on a restructuring proposal) lasts 25 working days (40 working days if the period for execution of the deed of company arrangement is included) in Australia, 60 days in Singapore and 28 days or 10 weeks in the UK, depending on the type of corporate rescue procedure.

[17] The impact may be different, depending on which option mentioned in Chapter 4 is adopted.

[18] For comparison, in the UK, Singapore and Australia (where some jurisdictions may have more than one type of corporate rescue procedure), the court may extend the initial moratorium period upon application. In the UK, one of the corporate rescue procedures does not provide for application to court for extension of the initial moratorium period but provides for extension by the decision of the meetings of creditors and the company (i.e. not by an application to court) subject to a maximum period of up to two months. Another corporate rescue procedure, apart from allowing application to court for extension, provides for approval by creditors' consent but subject to a limit of 28 days.

3.8 While the intent is to limit the length of the overall moratorium to ensure prompt and focused action, we recognise that in exceptional circumstances, the provisional supervision process for a large company may take longer. We consider that as a safeguard, any extension beyond six months from the commencement of the moratorium should only be granted by the court on application by the provisional supervisor. To avoid any undue delay, any court extension should not exceed a maximum of 12 months from the commencement of provisional supervision.[19]

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.

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.

III. Exemption from Moratorium

3.9 As stated in paragraph 3.4(b) above, due to the nature of those dealings (see footnote 14), certain financial contracts were proposed to be exempted from the moratorium (i.e. those dealings can still be conducted during the moratorium). The 2001 Bill listed 12 types of contracts and agreements to which the moratorium did not apply. The list is reproduced at Appendix. As the financial market has undergone significant development in recent years, the list of exempted financial contracts may be outdated. Therefore, we would like to invite suggestions, if any, on revisions and/or updates to the list.

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.

[19] Singapore and the UK each have a corporate rescue procedure which provides for automatic end of the procedure at the end of 180 days and one year respectively after commencement, effectively terminating the moratorium at the same time. However, the procedure and the moratorium can be extended by court on application, and there is no time limit on such extension by court. Further, in the UK, apart from approval by the court, the extension can be approved by creditors' consent but subject to a limit of six months.

CHAPTER 4

EMPLOYEES' OUTSTANDING ENTITLEMENTS

Background

4.1 During the deliberations of the 2001 Bill, how to deal with outstanding wages and other entitlements owed by a company to its employees or former employees before it initiates provisional supervision was the most controversial and difficult issue. The LRC's 1996 Report recommended using the PWIF to meet the outstanding claims of those employees who were laid off by a company undergoing provisional supervision. The Government subsequently conducted a public consultation on the issue in 1998 - 99. The views received were divided. As representative bodies of employers and employees were against the proposed change to the use of the PWIF, the Government suggested in the 2001 Bill that either of the following conditions had to be met before a company could initiate provisional supervision:

(a) clearing all arrears of wages, severance payments and other statutory entitlements under the EO owed to its former employees[20] before the commencement of provisional supervision and all arrears of wages owed to its existing employees up to the commencement of provisional supervision; or

(b) setting up a dedicated trust account that covered all arrears of wages, severance payments and other statutory entitlements under the EO owed to its former employees before the commencement of provisional supervision and all arrears of wages owed to its existing employees up to the commencement of provisional supervision.

If the company opted for condition (b), the provisional supervisor would be required to pay the employees from the trust fund as soon as practicable after the commencement of provisional supervision but before the meeting of creditors (referred to as the "second meeting of creditors" under our current proposals) convened by the provisional supervisor to consider the proposal.

4.2 At the Bills Committee stage, some business and professional bodies raised the concern that the requirement of finding cash to pay off its employees in full would be too onerous for financially-distressed companies and act as a major obstacle to using provisional supervision. Moreover, there was also

[20] Including those employees whose contracts of employment would be terminated on or after the commencement of provisional supervision.

objection to employees enjoying a more favourable treatment than in the case of winding up, as no limit was set on the amount of employees' entitlements.

4.3 The Government put forward a revised proposal in September 2003 to cap the trust account amount to mirror that of the PWIF ("the 2003 Proposal").[21] That would ensure that employees would be treated no worse off than if the company had gone into insolvent liquidation. The voluntary arrangement proposal was required to contain terms for paying the company's employees (including former employees) any outstanding amounts above the cap within 12 months of the approval of the proposal.[22] We consulted interested parties who had made submissions to the Bills Committee before. A total of 18 submissions were received in late 2003. The majority of respondents indicated general support, though some still had strong reservation as they considered that the proposal still presented a significant impediment to using provisional supervision. Nevertheless, the 2001 Bill was allowed to lapse in view of the limited time left before the LegCo session ended in July 2004.

Consideration and Proposals

4.4 While the revised proposal outlined in paragraph 4.3 above received majority support in the restricted consultation conducted in 2003, we notice that some insolvency practitioners, banks and academics have raised concerns that this approach would unnecessarily restrict the use of provisional supervision, as a company in financial distress may have difficulty in finding sufficient cash to settle the employees' outstanding claims, even though the amount is capped. The company would however be in a better position to raise funds to settle the employees' claims after the initiation of provisional supervision, as any new debts will receive "super" priority.[23] Even at its best, the 2003 Proposal would probably cause delay while the company tried to amass the required amount, adversely affecting the chances of success, as corporate rescue is time critical.

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[21] See footnote 7. The current PWIF cap is $278,500 per employee. The breakdown of the maximum amount payable is as follows:
(a) Arrears of wages: wages for services rendered during the four months prior to the last day of service but not exceeding $36,000;
(b) Wages in lieu of notice of termination: wages in lieu of notice up to one month's wages or $22,500, whichever is the lesser; and
(c) Severance payment: severance payment up to $220,000 being a sum of $50,000 plus 50% of the balance of any entitlement under the EO in excess of $50,000.

[22] The implications of the 2003 Proposal were set out in Annex B to the Consultation Paper issued in September 2003. The 2003 Consultation Paper is available at http://www.legco.gov.hk/yr00-01/english/bc/bc12/papers/bc12cb1-2463-1e.pdf

[23] Under the 2001 Bill, borrowing made by the company in provisional supervision would receive priority over all existing debts, with certain exceptions. This is intended to facilitate a company under rescue to raise capital to fund its operations during the provisional supervision period. We **propose** to retain this feature in our new framework.

4.5 Working on the principle that employees should not be treated less favourably than in winding up, we have explored two other alternative options ("Alternative A" and "Alternative B") set out below. While each has some pros and cons, both options replace the onus of having to set up a trust account with arrangement that may be more attainable for a company in financial distress. We would like to invite views on all three options (namely, the 2003 Proposal, Alternative A or Alternative B) before forming a final view on the issue.

Alternative A*: *Exempting employees who are owed wages or other entitlements from the moratorium

4.6 This option would exempt from the moratorium any current or former employee who is owed arrears of wages or whose statutory entitlements under the EO have become due and payable due to redundancy or other reasons, by preserving his right to petition to the court to wind up the company even after the commencement of provisional supervision. While this may serve to improve employees' protection, such extension would relatively raise the degree of uncertainty in carrying out provisional supervision, increasing the difficulty in achieving a successful turnaround plan.

4.7 The aim of this option is to encourage the company (through its own means or through assistance of others, such as its creditors or potential white knight) to find the money to settle all employees' outstanding wages and entitlements so as to eliminate any uncertainty that may arise due to the employees' exemption from the moratorium. While there may be concerns that this would introduce considerable uncertainty, or give special bargaining power to individual employees and may be considered unfair to other creditors who are subject to the moratorium, the underlying principle is that employees themselves are vulnerable and this option recognises that one of the considerations behind the review of corporate rescue is the protection of employees' rights. The CO already acknowledges the special position of employees in giving them priority status during insolvent liquidations.

4.8 This is the cleanest way to proceed on three levels. First, it would fit neatly into the current procedures in the sense that it would have no impact on the EO or other provisions of the CO, as an employee with a claim could still serve a statutory demand in the normal way. Secondly, it would be cheap to operate in practical terms, as it would not have a series of procedural checkpoints, such as in Alternative B below. Thirdly, it would be a simple mechanism, which should be easier to amend in future than an option that required substantial procedural provisions and legislative amendments to other Ordinances.

4.9 While this option does not provide for a statutory upfront settlement, it provides impetus for the company to address employees' outstanding entitlements to safeguard the smooth progress of the provisional supervision process.

Alternative B*: *According priority to employees' debts in a rescue plan

4.10 Under this alternative, the arrears of wages and other entitlements under the EO owing before the commencement of provisional supervision subject to the PWIF caps[24] would be treated as "employees' protected debts".[25] There would be no requirement for the company to settle those debts before initiating provisional supervision. However, any proposal put forward by the provisional supervisor to the meeting of creditors[26] within the 45-day[27] moratorium would contain provisions that (a) any outstanding "employees' protected debts" must be paid by the company in cash before or by the time the voluntary arrangement comes into effect; and (b) the remaining employees' debts must be paid within 12 months.

4.11 If a voluntary arrangement proposal or a resolution to extend the moratorium is voted down by creditors, or the provisional supervisor calls a meeting of creditors where he is satisfied that none of the purposes of provisional supervision can be achieved, creditors' voluntary winding up would follow, as it is a cheaper alternative to winding up by court.[28]

4.12 This option 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 to make the petition. The practical impact of such an expansion may not be significant, because if provisional supervision was not pursued, the PWIF probably would have to pay the employees in any event if the employees or creditors petitioned for winding up of the company by the court and the company's assets were inadequate to settle those amounts.

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[24] See footnote 21.

[25] We are indebted to Professor Charles D. Booth and the late Professor Philip Smart, who put forward a similar proposal back in 2001, see Charles D. Booth and Philip Smart, "Provisional Supervision and Workers' Wages: An Alternative Proposal", (2001) 31 *Hong Kong Law Journal* 188.

[26] This would be the second meeting of creditors under our current proposed approach, applicable to all employees' entitlement alternatives.

[27] See paragraphs 3.5 to 3.6 above for discussion of the duration of the initial moratorium.

[28] There is also a remote possibility that the outcome of the voluntary arrangement might be the winding up of the company by creditors' voluntary winding up after disposal of the company's property.

4.13 An amendment would be needed for the Protection of Wages on Insolvency Ordinance (Cap 380) so as to allow employees to claim ex-gratia payments from the PWIF under such circumstances.[29] In order to shorten the processing time of the applications, the provisional supervisor could be required to pass the information on the "employees' protected debts" to the PWIF immediately after the second meeting of creditors in the circumstances as specified in paragraphs 4.11 to 4.12 above.

4.14 In case it proved necessary to extend the moratorium period beyond the initial period, an extension could not be made unless the company could settle all outstanding "employees' protected debts" within 14 days of the granting of extension. Any voluntary arrangement proposal achieved in due course would have to contain the provision that the remaining employees' debts must be settled within 12 months from the start of the voluntary arrangement.

4.15 This approach would give the company valuable breathing space of some 45 days to organise its finances to meet its employees' claims. As there is currently a time-lag while employees apply for legal aid and then petition to the court for winding up, employees should not be significantly worse off than in the case of insolvent liquidation. Even in case where provisional supervision was extended beyond the initial moratorium period, employees would be able to receive payment of their "protected debts" within some eight weeks. Such a delay would not be markedly different from the timeframe for the PWIF to effect payment to eligible applicants. (The current performance pledge is within 10 weeks upon receipt of all relevant information and documents.)

4.16 It is noted that, under PWIF's current statutory operations, ex-gratia payment can only be made by the PWIF in a winding up by the court. However, there may be concerns that this option, if implemented, would possibly adversely impact on the PWIF's financial health. There may also be concerns about possible abuse by unscrupulous employers, who may try to make use of the proposed procedure as a legal cover to delay repayment. Procedurally, this alternative may also be more expensive to administer by a provisional supervisor.

[29] In general, ex-gratia payment can only be made by the PWIF in a winding up by the court but not in a creditors' voluntary winding up. However, under section 18 of the Protection of Wages on Insolvency Ordinance, the Commissioner for Labour may waive the requirement for a petition if in his opinion:
(a) the employment size of the insolvent employer is less than 20;
(b) sufficient evidence exists to support the presentation of a winding-up/bankruptcy petition; and
(c) it is unreasonable or uneconomic to present the petition.

Treatment of Outstanding Employers' MPF Scheme Contributions[30]

4.17 We would like to invite views on the treatment of outstanding employers' MPF scheme contributions.[31]

4.18 Under the 2003 Proposal and Alternative B, if outstanding employers' MPF scheme contributions were to be taken into account, the trust fund and the employees' protected debt amounts would accordingly be raised by the amount of outstanding contributions, thereby further raising the threshold for triggering provisional supervision and making it more difficult for companies in financial distress to make use of the procedure.

4.19 In the case of Alternative A, if similar consideration were to be so extended, that would mean that employees who are owed employers' MPF scheme contributions (with or without being owed wages or other statutory entitlements under the EO) would have the right to be exempted from the moratorium and petition for winding up. This would result in increased uncertainty for the rescue process, though, as explained above, this would provide clear incentive for employers to settle the outstanding amounts prior to triggering provisional supervision.

4.20 While outstanding employers' MPF scheme contributions form part of employees' outstanding entitlements and one view is that they should be treated the same as other entitlements, others may argue that factoring in outstanding employers' MPF scheme contributions will further raise the threshold for triggering provisional supervision or the level of uncertainty and make it more difficult for companies in financial distress to make use of the procedure.

4.21 We therefore would like to raise for consultation whether outstanding employers' MPF scheme contributions should be treated in the same way as employees' arrears of wages and other outstanding entitlements under the EO under the option to be adopted.

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[30] To facilitate easier reading, we refer only to employers' MPF scheme contributions in the main text for discussion. Indeed, similar issues and consideration apply to employers' ORSO scheme contributions which are not covered by the PWIF.

[31] The consideration for employees' MPF scheme contributions is relatively straightforward, as those contributions form part of wages as long as employers have made those contributions from the employees' wages on the employees' behalf. If employers default on those sums, those sums are treated in the same way as arrears of wages, and are covered by the PWIF in the event that the company is wound up and the company's assets cannot cover those sums, subject to the maximum stated in footnote 21. Outstanding employees' MPF scheme contributions therefore do not complicate the three options we put forward above.

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.

Question 10

Independent of which of the above options is adopted, what are your views on the treatment of outstanding employers' MPF scheme contributions[32]?

[32] As stated in footnote 30 above, this question applies equally to outstanding employers' ORSO scheme contributions which are not covered by PWIF.

CHAPTER 5

PROVISIONAL SUPERVISOR

Background

5.1 The 2001 Bill proposed that the provisional supervisor would be selected from a panel of practitioners to be operated by the OR and comprising solicitors and professional accountants. The OR might also approve other suitably qualified independent persons who were not members of the panel as provisional supervisors.

5.2 The provisional supervisor would manage and control the company, acting as the agent of the company when exercising his powers. He could retain or dismiss directors of the company, make alternative arrangements for any creditor and exclude some creditor from the moratorium, and was personally liable for any contract he entered into when performing his functions, including the pre-existing employment contracts accepted by him within 14 days after the commencement of provisional supervision (i.e. ensuring full payment of employees' entitlements incurred after the commencement of provisional supervision for those retained employees) and the new employment contracts he entered into. He would be indemnified out of the assets of the company.

5.3 The provisional supervisor would be remunerated in accordance with a scale of fees approved by the OR. The court could vary the fees upon application.

Consideration and Proposals

I. Qualifications

5.4 In Hong Kong, while debt and business restructurings are not uncommon, there is no established professional qualification or licensing system for professionals engaged in such operations. Many active restructuring professionals have accounting or legal backgrounds, and some hold qualifications (usually insolvency practitioner licences) from overseas.

5.5 The LRC recommended that in most cases provisional supervisors should only be selected from a panel comprising solicitors and professional accountants to be operated by the OR. It envisaged that the panel would be similar to the administrative panels of insolvency practitioners for the winding up of companies by the court. Panel members would have to meet certain criteria to demonstrate that they possessed the necessary expertise

and resources (e.g. certain number of qualifying hours of relevant experience). The LRC's recommendation was reflected in the 2001 Bill. On reflection, while the proposed panel system was intended to provide reassurance as to the quality of provisional supervisors, it would require considerable time and resources for setting up the screening process, as well as the appeal and disqualification procedures. The criteria for appointment to the panel would also be open to debate. If the criteria for appointment are strict, there would be concern about the dangers of a closed shop and high fees being charged by provisional supervisors.

5.6 To enable provisional supervision to come on stream quickly and to streamline the appointment requirement, one possible option is to make all solicitors holding a practising certificate issued under the Legal Practitioners Ordinance (Cap 159) and certified public accountants registered under the Professional Accountants Ordinance (Cap 50) eligible to be appointed as provisional supervisors so long as they are independent from the company. While not all accountants or lawyers have the relevant experience, the creditors will have a choice on the provisional supervisor together with his remuneration at the first meeting of creditors. In the event that there are complaints against the provisional supervisor's conduct, such complaints will be referred to the relevant professional body for investigation and disciplinary action as appropriate. Additionally, the imposition of personal liability on the provisional supervisor for any trading or contracts during provisional supervision (see paragraph 5.14 below) will also serve to deter unsuitable persons (or connected persons) from accepting the appointment without due regard to the state of affairs of the company.

5.7 There has been a suggestion that only accountants who hold a practising certificate (i.e. auditors only) should be automatically qualified. We are mindful, however, that auditing qualifications are not necessarily relevant to corporate restructuring/insolvency experience and should not, therefore, be added as a hurdle.

5.8 The LRC recommended that, in exceptional cases, the court might approve the appointment of a person who was not on the panel but who was particularly suited to the task of rescuing a particular company.[33] We are also aware that a number of restructuring professionals in Hong Kong who hold relevant qualifications from overseas (e.g. insolvency practitioner licences), or possess relevant local and/or overseas experience in corporate restructuring or voluntary workouts, may not satisfy the qualification requirements proposed in paragraph 5.6 above. In the 2001 Bill, the OR might appoint a fit and proper person who was not on the panel but had

[33] This could be a "company doctor", which commonly refers to an experienced businessman with no particular professional qualifications, who is brought into an established, but uncompetitive or unprofitable, company to restore the company to a competitive and/or profitable state.

suitable skills to be a provisional supervisor.

5.9 At the same time, some may argue that any person should be eligible for appointment as provisional supervisor, subject to the approval of the meeting of creditors. Since the experience or background required for each case varied widely depending on the type of business and the special circumstances of the company in question, the suitability of the provisional supervisor should be left for the creditors to decide. While this approach allows for greater flexibility, we consider that there must be sufficient protection against potential collusion between the company and provisional supervisor, and proper oversight of the conduct of the provisional supervisor. Some protection is built into the method of voting at meetings of creditors (see paragraphs 8.1(c) and 8.2(c) below regarding unconnected creditors). However, the additional safeguard of imposing personal liability on the provisional supervisor should be part and parcel of the formulation (see paragraphs 5.16 (a) to (c) below).

5.10 Independent of which approach is adopted, there are valid concerns about how persons without the necessary professional qualifications can be effectively regulated if they do not belong to any statutory professional body and are not subject to any code of conduct or established investigation and disciplinary mechanism. Moreover, a provisional supervisor would in any event have the power to appoint other persons in the performance of his functions or to do any business that may not be conveniently done by himself. Therefore, persons who are neither solicitors nor accountants should have sufficient opportunity to participate in provisional supervision.

5.11 Before taking a final view on the matter, we would like to invite views on the qualification requirements for the provisional supervisor, and if the proposed approach in paragraph 5.6 above is adopted, whether persons not satisfying the qualification requirements proposed should be eligible to be appointed as provisional supervisors in exceptional circumstances, on a case-by-case basis. If so, we would like to invite comments on whether such an appointment should be made by the OR or the court, and what safeguards should be introduced in case of complaints about his conduct.

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?

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.

II. Appointment and Remuneration

5.12 Some overseas jurisdictions, like Australia, allow creditors to have a say in the choice and remuneration of their equivalents of provisional supervisors. This would give sufficient checks and balances on the choice and remuneration of provisional supervisors. Although we note that there are concerns that some creditors (especially the smaller ones) may not possess sufficient information to make an informed decision, we consider that this approach would allow the necessary flexibility for individual cases and on balance suitably give creditors more involvement and control during the provisional supervision process. A similar approach is adopted in a winding up by the court under the CO, whereby creditors would oversee the liquidator's remuneration through their representatives on the Committee of Inspection.

5.13 We therefore **propose** to give 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. As a result, there is no need for the OR to set a scale of fees for provisional supervisors.

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.

III. Personal Liability

5.14 We have reviewed the proposal in the 2001 Bill, which would make provisional supervisors personally liable for any contracts they had entered into when performing their functions. We **propose** that this should be retained, with the period for a provisional supervisor to decide whether to accept pre-existing employment contracts to be extended from 14 days after the commencement of provisional supervision to 16 working days after the commencement of provisional supervision.

5.15 We are aware of concerns that imposing personal liability may deter experienced professional from taking up provisional supervisor appointments. However, the imposition of personal liability on the provisional supervisor regarding contracts entered into by him in the performance of his functions is in line with personal liability currently imposed on a receiver or manager of the property of a company under the CO, and that personal liability is imposed on the equivalent of provisional supervisors in other jurisdictions[34].

5.16 Personal liability on provisional supervisors would serve the following purposes:

(a) to strongly encourage provisional supervisors to perform due diligence prior to accepting the appointment, and to exercise prudence and good judgment during provisional supervision;

(b) to bolster the confidence of creditors to continue trading with the company with the provisional supervisor's personal guarantee; and

(c) to deter unqualified or connected persons from taking on such appointment without due regard to the company's state of affairs.

5.17 We **propose** that the provisional supervisor should have 16 working days after the commencement of provisional supervision to decide whether to accept pre-existing employment contracts and he will only be personally liable for those contracts he accepted within those 16 working days (i.e. for entitlements accrued since the commencement of provisional supervision). Since the creditors can now replace the provisional supervisor at the first meeting of creditors, which must be held within the first 10 working days, in case there is a replacement provisional supervisor, he will still have six working days following the meeting of creditors to consider whether he will

[34] Australia and Singapore also imposes personal liability on their equivalent of provisional supervisors. While the UK does not impose statutory personal liability, in practice, trading partners may require the equivalent of provisional supervisors to contract on terms that such provisional supervisors undertake a personal liability before they continue to trade with a company undergoing corporate rescue.

accept the pre-existing employment contracts.

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).

CHAPTER 6

INSOLVENT TRADING

Background

6.1 In the 2001 Bill, in order to encourage directors and senior management to act on insolvency earlier rather than later, they would be made personally liable for the debts of a company which traded while insolvent. The liquidator of a company would be empowered to make an application to the court to seek a declaration that a "responsible person" was liable for insolvent trading when a company went into liquidation. Under the 2001 Bill, a "responsible person" was defined as a director, a shadow director or a member of senior management. The grounds on which the court might declare a "responsible person" liable for insolvent trading were as follows:

(1) (a) the responsible persons **knew or ought reasonably to have known** the company was insolvent or **knew or ought reasonably to have known** that there was no reasonable prospect that the company could avoid becoming insolvent; or

(b) there were **reasonable grounds for suspecting** that the company was insolvent or there was no reasonable prospect that the company could avoid becoming insolvent,

and

(2) the responsible persons failed to take any steps to prevent the insolvent trading.

6.2 The insolvent trading provisions were intended to be applicable to companies in general and not only in the context of provisional supervision. However, these provisions would in effect serve as an incentive to induce responsible persons to initiate provisional supervision earlier, rather than resorting to insolvent trading before liquidation.

6.3 During scrutiny of the 2001 Bill, some stakeholders from the business sector expressed concerns that the insolvent trading provision would discourage directors and senior management from taking any risk and would not be conducive to business operations.

6.4 Having reviewed this issue, and having made reference to the regimes in other jurisdictions,[35] we remain of the view that some form of insolvent trading provision is needed to complement provisional supervision by encouraging directors to act on insolvency earlier rather than later to prevent further erosion of the distressed company's assets at the detriment of creditors.

Proposals

6.5 To address the business sector's concerns, we **propose** two adjustments to the insolvent trading provision:

(a) *Excluding senior management from being liable under insolvent trading.* Notwithstanding the LRC's recommendation in this regard (see paragraph 1.5 above), we consider that there will unavoidably be questions as to who is a "senior manager". We have also made reference to the insolvent or wrongful trading provisions in other major common law jurisdictions, such as Australia and the UK, and note that the relevant provisions in those jurisdictions do not cover senior managers. We therefore consider it appropriate to retain liability for directors (including shadow directors), while exempting senior management from being liable for insolvent trading; and

(b) *Modifying the standard in establishing liability.* Among the grounds to establish liability for insolvent trading as set out in paragraph 6.1 above, we **propose** dropping ground (1)(b) to impose a higher standard in establishing liability so as to address the business sector's concerns. As a result, responsible persons will only be held liable if they **knew or ought reasonably to have known** the company was insolvent or **knew or ought reasonably to have known** that there was no reasonable prospect that the company could avoid becoming insolvent. A reasonable suspicion of the company's insolvency will not suffice.

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.

[35] UK's "wrongful trading" provisions and Australia's "insolvent trading" provisions.

Question 16

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

CHAPTER 7

SECURED CREDITORS

Background

7.1 Under the 2001 Bill, immediately following the commencement of provisional supervision, the provisional supervisor would serve notice on each major secured creditor (if any) within three working days.

7.2 A "major secured creditor" was defined in the 2001 Bill as:

(a) the holder of a charge, whether fixed or otherwise, over the whole or substantially the whole of the company's property; or

(b) the holder of two or more charges, whether fixed or otherwise, on the company's property where the property subject to those charges constitutes the whole or substantially the whole of the company's property.

7.3 The major secured creditor would have three working days to decide whether or not to participate in the provisional supervision. If a major secured creditor objected, the provisional supervision would cease.

7.4 As for the other secured creditors, the original approach in the 1996 Report was that they would be bound by a moratorium in the same way as unsecured creditors. The LRC's reasoning was two-fold: (a) there could be a considerable number of them; and (b) it had frequently been commented on by practitioners that creditors secured for smaller amounts tended to obstruct reorganisation plans in the hope of being bought out by the other creditors.[36] Moreover, a secured creditor would not be entitled to vote in the meeting of creditors[37] except to the extent that he was under-secured.[38]

7.5 Nevertheless, in view of the impact on the existing secured lending practice, the lending institutions and the business community if all minor secured creditors are to be bound, the Government proposed in the 2001 Bill that the rights of all secured creditors may not be affected by the voluntary arrangement except with their consent. If a proposal was not acceptable to a secured creditor, although he was still bound by the moratorium, he might choose to opt out of the voluntary arrangement and rely on his own security

[36] See paragraph 13.14 of the 1996 Report.

[37] All creditors formed one class in voting. This approach was adopted for its clarity and simplicity, and which was important to the time-critical provisional supervision.

[38] A secured creditor, except to the extent that he was under-secured, would not be entitled to vote in the meeting of creditors, including the meeting to approve the extension of moratorium beyond the initial moratorium period.

after the moratorium had ended.

Consideration and Proposals

7.6 While some academics have questioned that the proposed regime in the 2001 Bill is creditor-oriented and to some extent undermines the potential for provisional supervision,[39] we consider the protection of secured creditors' rights in the 2001 Bill is justified and should be retained. Generally speaking, secured creditors' rights have been well protected in comparable jurisdictions like the UK and Australia in passing a proposal affecting their rights.

7.7 As regards the definition of "major" secured creditor, some may argue that it is not sufficiently clear. We are however mindful that the alternative of defining it by way of a particular percentage of the company's assets would result in delay due to valuation and calculation difficulties.

7.8 We are nonetheless open to public views on the above issues before taking a final view.

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.

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.

[39] See, for example, Ye Bingkun and Sa Xiaoli, "Hong Kong Corporate Rescue: Developments and Debate from a PRC Mainland Judge's Viewpoint", in Katarzyna Gromek Broc and Rebecca Parry (eds), *Corporate Rescue: An Overview of Recent Developments* (Kluwer Law International, 2nd edn, 2006), pp 199-214.

CHAPTER 8

VOTING AT MEETINGS OF CREDITORS

Background

8.1 Under the 2001 Bill, for any resolution to pass at a meeting of creditors approving or modifying the voluntary arrangement proposal, three conditions had to be met:

(a) majority in number of the creditors present in person or by proxy and voting on the resolution (known as the "headcount test");

(b) in excess of 66⅔% in value of the creditors present in person or by proxy and voting on the resolution; and

(c) no more than 50% in value of those creditors who are not connected[40] with the company have voted against it.

8.2 In respect of any other resolution proposed at the meeting of creditors, three conditions had to be met:

(a) majority in number of the creditors present in person or by proxy and voting on the resolution (i.e. "headcount test");

(b) in excess of 50% in value of the creditors present in person or by proxy and voting on the resolution; and

(c) no more than 50% in value of those creditors who are not connected with the company have voted against it.

Proposals

8.3 In the past, the headcount test was served as a means to ensure that employees' and small creditors' voices are heard, even if the amount collectively owed to them is a smaller portion than that owed to a few major creditors.

8.4 There are some concerns that such a requirement has the potential to distort voting at creditors' meetings. Unless the moratorium imposes further

[40] A person is connected with a company if:
(a) he is a director or shadow director of the company or an associate, within the meaning of section 51B of the Bankruptcy Ordinance (Cap 6), of such director or shadow director; or
(b) he is an associate, within the meaning of section 51B of the Bankruptcy Ordinance, of the company.

restrictions, a creditor is free to assign the whole or part of his debts to others. It is therefore possible for debts to be assigned to a number of nominees in a deliberate attempt to manipulate the outcome of the vote required by the headcount test. Further, the headcount test operates to disadvantage creditors with large claims and may deter the company from entering into provisional supervision if it fears that a large number of creditors with relatively small claims would defeat the proposal for reasons unrelated to the best interests of the company and its creditors.

8.5 We would therefore like to invite views on whether to retain or remove the headcount test.

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?

LIST OF QUESTIONS FOR CONSULTATION

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.

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.

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.

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

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.

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.

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.

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.

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.

Question 10 Independent of which of the above options is adopted, what are your views on the treatment of outstanding employers' MPF scheme contributions[41]?

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?

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.

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.

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).

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.

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

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.

[41] As stated in footnote 30 above, this question applies equally to outstanding employers' ORSO scheme contributions which are not covered by PWIF.

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.

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?

Appendix

Contracts or Other Agreements to which the Moratorium Shall Not Apply

1. Currency or interest rate swap agreement

2. Basis swap agreement

3. Spot, futures, forward or other foreign exchange agreement

4. Cap, collar or floor transaction

5. Commodity swap

6. Forward rate agreement

7. Repurchase or reverse repurchase agreement

8. Spot, futures, forward or other commodity contract and financial futures contract

9. Agreement to buy, sell, borrow, or lend securities, to clear or settle securities transactions or futures contracts or to act as a depository for securities

10. Derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in any of items 1 to 9

11. Master agreement in respect of any agreement or contract referred to in any of items 1 to 10

12. Guarantee of the liabilities under an agreement or contract referred to in any to item 1 to 11