Rights, Powers and Duties of the Debtor and Creditors in Insolvency Proceedings in Hong Kong

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Drastic changes were made to Bankruptcy Law of Hong Kong after the British colony of Hong Kong became a Special Administrative Region of the People's Republic of China and the revised law came into operation in 1998. The author in this article explains the various issues and processes of "Liquidation of Companies" and the Corporate Rescue proposal known as "Provisional Supervision" under the "Companies (Corporate Rescue) Bill, 2001" in Hong Kong. When the company is under "Liquidation", the creditors' actions will be limited to the extent of realization of the property that is under charge to the secured creditors. But, in the case of "Provisional Supervision", all the creditors will be bound by a moratorium for an initial period of 30 days and it may extend to six months. The employees of insolvent company are entitled to priority of wage claims pursuant to Sec.265 of the Companies Ordinance. The liquidator of the company is empowered to sell the real and personal property of the company by public auction or private contract under Sec.198 and Sec.199 (2)(a) of the Companies' Ordinance. The purchasers of the corporate assets should take the necessary precautions to minimize their risks.

Background Information and New Reorganization Legislation

On July 1, 1997, the British colony of Hong Kong became a Special Administrative Region (SAR) of the People's Republic of China. The "one country, two systems" approach is embedded in the Basic Law (Hong Kong's new Constitution). Article 8 provides that the laws previously in force in Hong Kong—ordinances, subordinate legislation, the common law, rules of equity, and customary law—shall continue to apply in Hong Kong after the transition, except to the extent that they contravene the Basic Law or are amended by the legislature of the Hong Kong SAR. Although Hong Kong's insolvency laws have not been directly affected by the transfer of sovereignty, they nevertheless are in the midst of great change—dramatic changes to bankruptcy law came into operation in 1998, legislative efforts are underway to enact a corporate rescue procedure called provisional supervision, and amendments to corporate liquidation law will be enacted within the next year.

In addressing the issues below, it is necessary to discuss the relevant Hong Kong terminology. In Hong Kong, the insolvency law of individuals is separate from that of companies. The former is called bankruptcy law and is contained in the Bankruptcy Ordinance (cap 6), as amended by the Bankruptcy (Amendment) Ordinance 1996, which came into operation on April 1, 1998. The insolvency law relating to companies is called liquidation (or winding up) law and is contained in the Companies Ordinances (cap 32). There are two types of liquidation procedures—voluntary winding up (a winding up without a court order) and

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winding up by the court (compulsory winding up). When discussing liquidation below, the discussion will focus on compulsory liquidations.

At present, there is no effective procedure in the Companies Ordinance (such as Chapter 11 in the United States) for restructuring or rehabilitating companies in Hong Kong. The primary corporate rescue procedure in the Companies Ordinance is included in Sec.166. Although this section may be utilized after a winding-up order has been made, a Sec.166 compromise or arrangement is typically proposed by either a company or its creditors as a means of avoiding liquidation. For a proposal to be binding on creditors or classes of creditors, it must be accepted by a majority in number and 3/4 in value of the creditors or classes of creditors (as the case may be) who are present and voting in person or by proxy. The sanction of the court is also necessary. However, there are many weaknesses with s 166, including the following:

- There is no stay to prevent secured creditors from realizing their security or unsecured creditors from bringing actions against or winding up the company;
- The matters involving the classification of creditors are very complex; and
- The process is time-consuming and expensive.

Given these deficiencies, there are few successful corporate rehabilitations under Sec. 166.

Because of the lack of an effective formal rescue procedure in Hong Kong, corporate rescue pursued through other avenues, such as receivership or the joint guidelines for multibank lending situations called the "Hong Kong Approach to Corporate Difficulties" (the "HK Approach") that have been issued by the Hong Kong Association of Banks and the Hong Kong Monetary Authority. [HKMA, Quarterly Bulletin, 9 (November 1999), available on the Web at http://www.info.gov.hk/hkma/eng/public/qb9911/toc.htm.] The HK Approach provides that once it is public knowledge that a debtor company is in distress, the banks' initial attitude should be supportive of the company—the banks should not withdraw credit facilities, hastily appoint a receiver, or issue writs for repayment. The HK Approach includes a stand-still process, which dramatically improves the likelihood of success in many cases, particularly where the banks control the majority of debt. But the HK Approach is less effective where the banks have a minority interest and/or where the banks are unable to gain the support of other creditors. Another weakness is that unanimity is required.

Although the HK Approach is an important development, there is still a need in Hong Kong for the enactment of an effective, formal corporate rescue procedure. In October 1996, the Law Reform Commission of Hong Kong issued its "Report on Corporate Rescue and Insolvent Trading", in which it proposed a new comprehensive provisional supervision system for restructuring companies in Hong Kong. This Report formed the basis for most of the provisions that were gazetted in January 2000 in the Companies (Amendment) Bill 2000. The proposed scheme was intended to provide a flexible framework for corporate rescue and involved the appointment of a provisional supervisor to take control of the company and to prepare a corporate rescue proposal, which would be put to creditors for their vote.

As provided in the Bill, provisional supervision would be available to both solvent and insolvent companies, and to both Hong Kong and foreign companies. The procedure would normally be initiated by the company's members by ordinary resolution or by the directors, but where a company was in the process of being wound up, a provisional liquidator or liquidator of the company would be able to commence the procedure with the approval of the court. However, a petitioner would be foolish to commence the procedure without first consulting the company's major secured creditors, because after the procedure is commenced...
such creditors would be given the right to determine whether the provisional supervisor should be permitted to proceed with preparing the proposal (i.e., whether provisional supervision should continue). Unsecured creditors would not be able to initiate the procedure. Court appearances by the provisional supervisor would be limited. The aim of the procedure was for the provisional supervisor to present a plan to creditors for their approval within six months of the commencement of provisional supervision, during which time creditors would be bound by a moratorium. For a plan to be accepted, creditors would vote in one class, and it would be necessary to secure the approval of a majority in number and in excess of 2/3 in value of all creditors voting on the resolution either in person or by proxy.

Despite the acknowledgment in Hong Kong of the pressing need for the enactment of an effective corporate rescue scheme, the provisional supervision scheme ran into serious opposition and was deleted from the 2000 legislative agenda. Two of the more controversial aspects of the Bill that led to this result were the following:

1. Permitting creditors generally to pass a proposal that impairs the rights of secured creditors without first securing the consent of the secured creditors; and

2. Requiring as a precondition to the commencement of provisional supervision that the company either

   - Pay-off all debts and liabilities owing to its employees under the Employment Ordinance (cap 57) as of the commencement date or
   - Open a trust account with a bank containing sufficient funds to pay-off all such debts and liabilities.

In May 2001, a revised Bill was gazetted, the Companies (Corporate Rescue) Bill 2001. Although the new Bill resolved the problems regarding the treatment of secured creditors, it too ran into difficulty in regard to the treatment of payments to workers. The new Bill continues to require a company to settle all outstanding debts and liabilities owed to workers before commencing provisional supervision. (See the Legislative Council Panel on Financial Affairs, Introduction of a Statutory Corporate Rescue Procedure in Hong Kong—Report on Consultation on the Proposed Flexibility on the Settlement of Outstanding Wages and Other Entitlements (February 5, 2001). This issue is discussed more in detail later in "The Powers, Priorities and Rights of Employees in Insolvency Proceeding". For an analysis and critique of the proposed provisional supervision procedure, see Philip Smart and Charles Booth, "Corporate Rescue in Hong Kong: This Year, Next Year . . .", Global Insolvency and Restructuring Review 13 (March/April 2001). [An earlier version of this article was published in the Hong Kong Lawyer 50 (June 2000) and may be found on the Web at http://www.hk-lawyer.com/2000-6/Default.htm.]

For further discussion and analysis of corporate insolvency in Hong Kong, see Philip Smart, Charles D. Booth and Stephen Briscoe (eds), Hong Kong Corporate Insolvency Manual (2002).

If a Corporate Debtor is in a Liquidation or Provisional Supervision Case, is Management Automatically, or for Cause, Displaced by a Liquidator or a Provisional Supervisor? What are the Criteria for Displacing Management?

In both liquidations and provisional supervision, management is automatically displaced. In a liquidation, the directors' powers cease upon the appointment of a provisional liquidator
(who may be appointed at any time after the filing of the winding-up petition, but at the latest upon the making of the winding-up order). Similarly, in provisional supervision management will be displaced upon the appointment of a provisional supervisor. There is a strong reluctance in Hong Kong to allow the management that oversaw a company during its decline to continue running the company after a formal insolvency or reorganization procedure has been commenced.

However, a liquidator may confer limited powers of management back on the displaced directors and even appoint them as special managers. Similarly, in provisional supervision the provisional supervisor will also be permitted to delegate powers back to the directors. In such cases, the directors remain answerable to the liquidator or provisional supervisor, as the case may be. Further details are provided below:

Liquidation

After the making of a winding-up order, the court may appoint a provisional liquidator (CO, s 193), and if it does so, the court usually appoints the Official Receiver. Upon the making of the winding-up order, the Official Receiver becomes the provisional liquidator (ibid, s 194) unless a person other than the Official Receiver has been appointed provisional liquidator under Section 193. The provisional liquidator continues to serve until he or another person is appointed liquidator. The practice, until the mid-1990s, was for private liquidators to be appointed in complicated cases and for the Official Receiver to serve in less-complicated ones. However, in 1995 the Official Receiver introduced a scheme to contract out non-summary court winding-up cases (cases in which the net realizable assets are likely to exceed HK$200,000) and set up an Administrative Panel of Insolvency Practitioners for Court Winding Up. This panel is known as the Panel A scheme. To be on the List A Panel, a firm of accountants must be experienced in insolvency work (meeting certain minimum requirements) and must show that it has sufficient resources to carry out work of this type. In 2000-2001, private sector liquidators were appointed by the court in 79 cases and a special manager in one case.

In 1998, the Official Receiver established a pilot scheme for summary cases, which is known as the Panel B scheme. Under this scheme, the Official Receiver served as the liquidator, and a member of the List B Panel was appointed to serve as a special manager. The List B Panel scheme was suspended because of delegation problems and eventually replaced by a delegation procedure whereby firms could tender for summary winding up cases and private practitioners could be appointed as provisional liquidators.

At present the usual practice is for the Official Receiver to serve initially as provisional liquidator. In cases where there are sufficient assets to justify an appointment from the List A Panel, the Official Receiver will then put forward to the creditors (and contributories) a recommendation of a panel member, in order of rotation, for confirmation as liquidator. The choice is usually accepted, but in cases where the creditors choose another liquidator, they usually choose another Panel A member (although they are not required to do so).

Provisional Supervision

The List A Panel process will be extended to provisional supervision. However, the appointment process will be different from liquidation in that the party that initiates provisional supervision (e.g., the company’s directors) will nominate the provisional supervisor from the panel, in order of rotation. Where the petitioner wishes to choose someone not on the panel, the permission of the Official Receiver will first have to be sought.

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Do the Directors of a Corporation Have Personal Liability if the Company Continues to Trade while it is Insolvent?

Liquidation

Section 275 of the Companies Ordinance provides that where a company is in the course of being wound up, directors may be held personally liable if they engaged in fraudulent trading, which is defined as the carrying on of the business of the company "with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose." This section may be applied against "any persons who were knowingly parties to the carrying on of the business in manner aforesaid." Fraudulent trading contains both a criminal and a civil sanction, but liability is rarely imposed. The criminal penalty is applicable regardless of whether the company is being, or has been, wound up. Section 275 was recently interpreted by the Court of Final Appeal in the case of Aktieselskabet Dansk Skibsfinansiering vs. Brothers, FACV No. 25 of 1998 (CFA, March 9, 2000).

The Companies (Amendment) Bill 2000 proposed to supplement s 275 with a civil sanction of insolvent trading which, unlike fraudulent trading, would be limited to insolvent companies in the course of being wound up. This provision was deleted in tandem with the provisional supervision sections and later reintroduced as part of the Companies (Corporate Rescue) Bill 2001. Under insolvent trading, only civil liability will be available. Responsible persons, including directors, shadow directors, and senior management, would become subject to liability for insolvent trading if a company incurred a debt at a time when the responsible person "knew or ought reasonably to have known that the company was insolvent" or that "there was no reasonable prospect that the company could avoid becoming insolvent." In addition, it will be sufficient if there were reasonable grounds for suspecting that the company was insolvent or that there was no reasonable prospect that the company could avoid becoming insolvent. Responsible persons will be provided with possible defenses. A responsible person will be able to avoid liability by proving that he took every step that ought to have been taken to minimize the potential loss to the company's creditors after the time that he became aware (or ought to have become aware) of the unavoidability of insolvency. In addition, senior managers will be provided with an additional defense. A senior manager will be able to escape liability by proving that before the company incurred debt whilst trading in insolvent circumstances, he issued a "warning notice" (in a specified form) to the board of directors.

Provisional Supervision

The provisions regarding fraudulent and insolvent trading will not be applicable in provisional supervision.

Does the Commencement of a Liquidation or Provisional Supervision Case Prevent Secured Creditors from Foreclosing on their Collateral? What Actions Must Secured Creditors Take in Order to be Able to Foreclose on their Collateral?

Liquidation

Secured creditors are in a very strong position in Hong Kong. They are not bound by the stay that operates in liquidation and are thus permitted throughout the liquidation process to exercise their contractual rights (which are usually set out in a debenture) in respect of security that is subject to a valid charge. Of course, the ability of a secured creditor to realize its security will be adversely affected in those cases in which a liquidator successfully asserts...
the application of an avoidance power. In addition, once a liquidation has commenced, a receiver and manager appointed pursuant to a floating charge is no longer permitted to carry on the business of the company as agent of the company. Rather his actions will be limited to realizing the property that is subject to the secured creditor’s charge.

Provisional Supervision

There will be a moratorium that will bind all creditors—both secured and unsecured. The moratorium will last for an initial 30-day period, which may be extended by the court for up to six months, and beyond that with the approval of creditors. However, there is an exception for “major creditors”. A major creditor is defined as “the holder of a charge, whether fixed or otherwise, over the whole or substantially the whole of the company’s property” immediately before the date on which a provisional supervisor may be appointed. Major creditors have the ability to avoid the application of the stay by deciding that the provisional supervisor should not proceed with preparing the proposal and thereby bringing provisional supervision to an end. If major creditors do not make this election, then they too will be bound by the moratorium and will not be permitted to appoint a receiver or to take any steps to enforce any security over the company’s property.

The Powers, Priorities and Rights of Employees in Insolvency Proceedings

Liquidation

In general, pursuant to Sec. 265 of the Companies Ordinance, employees are entitled to priority for pre-petition wage claims up to HK$8,000 for services rendered during the four months before the commencement of the case; severance payments up to HK$8,000; long leave service payments up to HK$8,000; compensation payments; wages in lieu of notice (up to the lesser of one month’s wages or HK$2,000); accrued holiday remuneration; and contributions due under the Occupational Retirement Scheme. These debts rank equally with each other and are payable before the other classes of priority payments. In practice, however, where a company is insolvent and a winding-up petition has been presented, workers who have not been paid first apply to the Protection of Wages on Insolvency Fund (the PWIF) for ex gratia payments in regard of wages, wages in lieu of notice, and/or severance payments. Payments from the PWIF can be substantially higher than the priority levels set out in Sec. 265 (e.g., a worker can receive up to HK$36,000 in back wages; and in cases where there is a substantial severance pay owed, a total pay-out of up to HK$258,500). Where the PWIF makes payments to workers, the PWIF, in turn, is entitled to the priority in the liquidation.

Provisional Supervision

The Law Reform Commission originally proposed that the commencement of provisional supervision should likewise trigger the onset of the PWIF scheme, but this recommendation was eventually rejected. Rather, both the Companies (Amendment) Bill 2000 and the Companies (Corporate Rescue) Bill 2001 both proposed that as a precondition to commencing provisional supervision, the company must first settle all outstanding debts and liabilities either by paying the workers directly or by setting up a trust account with sufficient funds to pay-off these obligations. This requirement will make it difficult for many companies to commence provisional supervision. Recently a revised proposal has been made to cap the amount that must be paid prior to the commencement at the same amount that may be paid to workers from the PWIF in a compulsory liquidation (HK$258,500, as noted above). This is better than requiring payment in full, but is still an onerous burden for a company.

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considering whether to commence a restructuring. Any amounts outstanding to workers will still have to be paid in full at a later date. For further discussion of the treatment of workers in provisional supervision, see Philip Smart and Charles Booth, "Provisional Supervision and Workers Wages: An Alternative Proposal", 31 Hong Kong Law Journal 188 (2001).

**Acquiring the Assets of the Insolvent Debtor: The Methods Available to Acquire the Assets; The Risks Inherent in the Acquisition; and the Benefits to Creditors**

A liquidator is empowered by s 199(2)(a) "to sell the real and personal property of the company and things in action of the company by public auction or private contract" without the need for approval of either the court or the committee of inspection. Where he sells the property, he does so in the name of the company unless the property has been vested in him under s 198 of the Companies Ordinance.

The listing status of a company is also a corporate asset that may be sold. There is precedent in Hong Kong that such a sale may be realized through a scheme of arrangement without the approval of the shareholders (since their shares are worthless), but that it was justified to give the shareholders a sweetener or token consideration in return for their cooperation. *Re Rhine Holdings Ltd.* (2000) 3 HKC 543. In that case the court reluctantly approved the scheme which split the consideration between the creditors and shareholders in a 60:40 split. The issue recently arose again in the case of *Re Yaohan Hong Kong Corp. Ltd. (in liq)* (2000) 4 HKC 488, in which the liquidators entered into a restructuring agreement with a party (which included a scheme of arrangement between the company and its creditors). The restructuring agreement in this case stated that the shareholders' approval was necessary and provided that the consideration would be split 33:67 between the shareholders and creditors. The court was critical of the fact that the liquidators never informed the creditors or the committee of inspection of the impact of *Re Rhine Holdings Ltd.* and therefore only reluctantly sanctioned the scheme upon the liquidators providing an undertaking to pay for the benefit of the creditors 1/2 of their own profit costs and 1/2 of the legal disbursements incurred in relation to the restructuring agreement.

Among some of the issues that purchasers of corporate assets from the liquidator should consider to minimize the risks inherent in such transactions are:

- To ensure that the liquidator has executed necessary documents under the company’s seal; and
- To be aware that the liquidator will not be able to accept conditions and warranties that are usual in other commercial transactions. Paul Shewall and John Powell, *Tolley’s Liquidation Manual* 98 (1993).

The liquidator may also sell the business of the company. One should be aware of the Transfer of Business (Protection of Creditors) Ordinance (cap 49), which makes a transferee of a business responsible for the debts of that business unless the transferee has complied with the procedures for the giving of notice. However, pursuant to Sec.10 of this ordinance, this ordinance does not apply to a transferee where the transfer is effected by the liquidator of a company in liquidation other than voluntary liquidation.

The liquidator may consider transferring the debtor’s business to a subsidiary specifically formed for the purpose, in a process that is known as a "hive-down". The advantages of a hive-down to the liquidator (and to the company’s creditors) are that:

• All normal business dealings with trade customers take place through the medium of the continuing company;
• Any exceptional commercial risks are borne to the subsidiary so far as normal commercial risks are concerned; and
• The major assets are all in an easily transferable package.

*Tolley's Liquidation Manual,* supra, at 97. The hive-down may enable the liquidator to transfer the goodwill and obtain a better purchase price for the company's undertaking. *Ibid.*

Who Oversees Compensation to the Insolvency Professionals?

There are different procedures regarding the compensation of insolvency professionals. Section 196(2) of the Companies Ordinance provides that where a person other than the Official Receiver has been appointed liquidator, his remuneration shall be by way of percentage or otherwise as determined (a) where there is a committee of inspection, by agreement between the liquidator and the committee of inspection or (b) where there is no committee or where the liquidator and committee are unable to agree, by the court. Companies (Winding-up) Rule 146(2) provides that where there is no committee, the liquidator's remuneration shall be fixed by the scale of fees and percentages for the time being payable on realizations and distributions by the Official Receiver as liquidator (unless otherwise provided for under the Companies Ordinance or ordered by the court). Where the Official Receiver is of the opinion that the remuneration of a liquidator should be reviewed, he may apply to the court and the court may make an order confirming, increasing or reducing the remuneration of the liquidator [CO, Sec. 196(2A)]. The Official Receiver has approved standard hourly rates for List A Panel liquidators, in consultation with the Hong Kong Society of Accountants.

The issue of the compensation of insolvency professionals is a lively one, having been sparked by a judgment in the liquidation proceedings arising from the collapse of Peregrine —*Re Peregrine Investments Holdings Ltd.* and Ors (1998) 3 HKC 1. The case involved a request by the provisional liquidators for payment of their fees and recoupment or reimbursement for professional fees incurred by them out of the assets of the companies in liquidation. The sums sought were substantial—HK$76 mn for the 63 days between the commencement of the provisional supervision and the making of the winding-up orders. The court set out the critical issue as to whether the provisional liquidators had discharged the burden of showing that the fees they sought were justified. Among the factors noted by the court were the following *(ibid, p 15):*

• Whether the provisional liquidators had sufficiently explained the nature of each task undertaken;
• Whether these explanations were properly linked to the time spent on the task;
• Whether a reasonably prudent man would have spent his own money on what the provisional liquidators did;
• Whether the provisional liquidators had produced contemporaneous time records of what they did and why they did it, as well as of all items of expenditure and of services rendered, how they were calculated, and how they were justified;
• Whether the fees for any item of work should be disallowed as being unnecessarily incurred; and
• Whether the fees for any item of work should be disallowed as being incurred in the breach of duties.

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As for the bills payable to the provisional liquidators' solicitors, the court stated that as between these parties there was a contract that the office-holder was personally bound to pay for work done according to the contract. The court had to assess what amount of the solicitors' fees should be payable out of the estate and the provisional liquidators were under a duty to subject the bills to scrutiny. The court found that the bills had not been subject to critical or serious scrutiny, but rather that the review had been "cursory, superficial, and lacking in particularity." Ibid, at 21. (Other compensation issues were also discussed in Re Peregrine Investments Holdings Ltd. & Ors [No. 2] [1998] 3 HKC 423.)

Since this decision in Peregrine, the issue of professional fees has been one that is closely watched by the courts. One of the effects of the case is that accountants and solicitors have reviewed their internal billing and record keeping practices.

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Hague Conference on E-commerce Treaty

During the meeting held on October 22 to 25 at the Hague Conference, the experts hailing from the United States and about twenty other nations from various parts of the world agreed to further continue their efforts in bringing out a draft treaty covering jurisdictional questions on cross-border, business-to-business (B2B) E-commerce transactions. Their main attention was focused on the choice of the court agreements in B2B contracts. The bone of contention was on the vital issue of specifying the jurisdiction of a particular country's court system in the contract, which will be used if a dispute arises over a transaction. They had also agreed to ascertain the public opinion in the respective countries of the participants whether the patents and the trademarks could be excluded from the treaty leaving only copyrights. The delegates also decided to hold the next meetings over these issues on January 6 to 9. Andrew Schulz, first Secretary at the Hague Conference Permanent Bureau said, "Where a contract contains an exclusive clause pointing to a specific court and the case is taken to another court, the second court should refuse the case."

Some more contentious issues also came for discussion. For instance, the Internet Service Providers (ISPS) might be dragged into courts in any other country in the world even if the contents covered in their networks is quite legal in their home country. But such cases like ISPS may not be held liable if the treaty focuses only on contracts between two parties. Some other controversial issues that came for discussion include the feasibility of choice-of-forum clauses in the treaty especially when a bilateral agreement exists in between the Hague signer and another third country.

It was also suggested that the jurisdiction of EU court would take precedence whenever it is designated in the agreement, that involves an EU company and a non-EU company from a Hague-treaty country. However, it is hoped that the draft treaty covering jurisdictional issues would be finalized in Hague Conference during the ensuing meetings as the differences among the participants on various important areas are gradually narrowing and converging towards a consensus on the proposed issues.

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