REFORMING CORPORATE RESCUE PROCEDURES IN HONG KONG

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The need for a statutory corporate rescue mechanism has long been recognised in Hong Kong. That need was heavily underscored by the recent Asian financial crisis. Following recommendations made in 1996 by the Law Reform Commission of Hong Kong, legislation was introduced in January 2000, in the form of the Companies (Amendment) Bill 2000. The Bill proposed a regime, to be known as "provisional supervision", which would allow a company – without having to go to court – to appoint an insolvency specialist to take over its affairs under the protection of a moratorium. Once appointed, the provisional supervisor would formulate a plan for voluntary arrangement for approval by the company's creditors. However, after serious opposition was raised against the Bill, the provisional supervision proposals were dropped. It is anticipated that a modified provisional supervision regime will soon be put back on the legislative agenda. This paper offers a critical analysis of the provisional supervision regime contained in the Bill, with particular emphasis on the Government's controversial proposals regarding the rights of secured creditors and the treatment of workers' wages.

Hong Kong's insolvency law has always borne close resemblance to its English counterpart, although this is scarcely surprising for a territory which was a British colony for 150 years.[1] Accordingly, it was to be expected that, following the introduction of the Insolvency Act 1986 (IA 1986), Hong Kong would conduct its own insolvency law reform exercise. In 1990 the Law Reform Commission of Hong Kong (LRC)[2] first took up the matter. A Sub-Committee on Insolvency was formed, and its deliberations were divided into three parts, namely personal insolvency, corporate rescue and winding-up.[3] More than a decade has now passed, but the reform process still has not been completed. Extensive amendments to the

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[1] The People's Republic of China, of course, resumed sovereignty over Hong Kong on 1 July 1997.

[2] The LRC is the rough equivalent of the Law Commission of England and Wales.

[3] Initially, the Sub-Committee divided the subject into two parts—personal insolvency and everything else but subsequently corporate rescue was hived off from winding-up to form a further separate report. See LRC, *Report on Corporate Rescue and Insolvent Trading* (Hong Kong, Government Printer, October 1996), paras 4 5 (hereafter "*Report*"); available at <http://www. info.gov.hk/hkreform/reports/index.htm>. The *Report* was preceded by a consultation paper (see The LRC Sub-Committee on Insolvency, *Consultation Paper on Corporate Rescue and Insolvent Trading* (Hong Kong, Government Printer, June 1995)).

Bankruptcy Ordinance were passed in 1996,[4] closely tracking Parts VIII and IX of the IA 1986. Similarly, the LRC's recent recommendations on winding-up[5] rely heavily on the current English legislation. However, in relation to corporate rescue, the LRC, whilst not ignoring English precedents, has chosen its own route.[6]

The LRC's recommendations were published in October 1996 but first emerged in legislative form in the Companies (Amendment) Bill 2000 (the Bill),[7] as a proposed new Part IVB ("Provisional Supervision and Voluntary Arrangements") of the Companies Ordinance (CO).[8] However, the provisions on corporate rescue met with criticism, and the Hong Kong Legislative Council Bills Committee decided in June 2000 that they needed to be reconsidered.[9]

This paper, after briefly outlining the impact of the Asian financial crisis upon corporate insolvency practice in Hong Kong, offers a critical appraisal of the provisional supervision regime as proposed in the Bill. Particular emphasis is given to the Government's controversial treatment of secured creditors and workers' wages: interestingly, in respect of both these issues, the approach taken in the Bill would appear to be a departure from the earlier recommendations of the LRC.[10]

A. Liquidations, workouts and the Asian financial crisis

The onset of the Asian financial crisis[11] in mid-1997 forcefully brought home the pressing need for a statutory corporate rescue mechanism in Hong Kong. For the first half of 1997, roughly 45 compulsory winding-up orders were made each month: the figure for the corresponding period in 1998 showed an almost 20% increase, and similar year-on-year increases occurred in 1999 and 2000.[12] There

[4] See Bankruptcy Ordinance (Cap 6), Laws of Hong Kong (LHK).

[5] *Report on the Winding-Up Provisions of the Companies Ordinance* (Hong Kong, Government Printer, July 1999); available at <http://www.info.gov.hk/hkreform/reports/index.htm>.

[6] The proposed provisional supervision regime is more similar to corporate voluntary administrations under the (Australian) Corporations Law 1989 (Cth), Pt 5.3A, than it is to administrations under IA 1986, Pt II.

[7] The Bill was gazetted on 7 January 2000. See *Hong Kong Government Gazette*, Legal Supplement No. 3, C5. The Bill and background materials are available at <http://www.legco.gov.hk/yr99-00/english/bc/bc06/general/ebc06.htm>.

[8] Companies Ordinance (Cap 32), LHK. The proposed Pt IVB consists of 33 sections, which would be added to the CO as ss 168U–168ZZA.

[9] See the postscript to this paper below for changes proposed in the recently published Companies (Corporate Rescue) Bill 2001, *infra* n. 91.

[10] As to which, see CD Booth, "Hong Kong Corporate Rescue Proposals: Making Secured Creditors More Secure" (1998) 14 *Insolvency Law and Practice* 248, 251–3; and *infra* n. 47 and accompanying text.

[11] See, generally, MD Ebert, "The Asian Financial Crisis and the Need for a New Global Financial Architecture" (1998) 13 *Butterworths Journal of International Banking and Financial Law* 454.

[12] The statistics are available at <http://www.info.gov.hk/oro/statistics/index.htm>. Note also J Yam, "Hong Kong: From Crisis to Recovery", *Quarterly Bulletin*, November 1999, 41; available at <http://www.info.gov.hk/hkma/eng/public/qb9911/toc.htm>.

are, of course, no statistics for corporate rescues, yet anecdotal evidence points to the inevitable increase in the number of companies that have sought to reschedule their debt or enter into informal workouts.[13]

In April 1998 the Hong Kong Association of Banks (HKAB) issued guidelines on corporate workouts,[14] such guidelines being closely modelled on the London Approach. The Hong Kong Monetary Authority (HKMA)[15] collaborated with the HKAB in formulating, in 1999, a revised set of principles, entitled the "Hong Kong Approach to Corporate Difficulties".[16] Like the London Approach, the Hong Kong guidelines are non-statutory and lack the support of an enforceable moratorium. At present, the only statutory option available to a company hoping to avoid liquidation is to formulate a scheme of arrangement pursuant to section 166 of the Companies Ordinance (identical to section 425 of the Companies Act 1985). Although a small number of schemes of arrangement in respect of insolvent companies have been successfully concluded in Hong Kong over the last couple of years,[17] the deficiencies of the scheme of arrangement as a corporate rescue mechanism require no elaboration.[18]

B. Provisional supervision

1. Introduction

In Hong Kong, unlike in England, it is not the practice of the LRC to include draft legislation with its reports.[19] Accordingly, whilst the LRC's report in 1996 set out the broad framework of the proposed provisional supervision regime, it was not until the Bill (in January 2000) that precise details became available. In general terms, however, the key characteristics of the provisional supervision regime as

[13] For details, see CD Booth, *Local Study of Insolvency Law Regimes: Report on Hong Kong, China* (Asian Development Bank's Insolvency Law Reform Project); available at <http://www.insolvencyasia.com/insolvency_law_regimes/hongkong/index.html >.

[14] See IF Fletcher and J McGuinness, "Export of London Approach to Hong Kong", *Recovery*, June 1999, 24.

[15] The HKMA functions in many respects as if it were a central bank for Hong Kong.

[16] HKMA, *Quarterly Bulletin*, November 1999, 13; available at <http://www.info.gov.hk/hkma/eng/public/qb9911/toc.htm>. D Carse, "Hong Kong Approach to Corporate Difficulties", *Quarterly Bulletin*, February 2000, 70; available at <http://www.info.gov.hk/hkma/eng/public/qb200002/toc.htm>.

[17] See, e.g. *Re Kansa General International Insurance Co Ltd* [1999] 2 HKLRD 429; on appeal, [1999] 3 HKLRD 94; and the comment by D Steinberg and R Gregorian [1999] *International Corporate and Commercial Law Review* 220.

[18] See The Report of The Insolvency Law Review Committee, *Insolvency Law and Practice*, Cmnd 8558 (1982) ("the Cork Report"), paras 400–430, for details.

[19] The Sub-Committee on Insolvency attached a "model Bill" to its 1995 consultation paper, *supra* n. 3. However, in the *Report, supra* n. 3 (Introduction, para. 10) the LRC revealed that "it was never intended that it [i.e. the model Bill] should be adopted as draft legislation".

proposed by the LRC—with the significant qualifications noted above[20]—are reflected in the Bill. A number of central features can be identified.[21]

First, rejecting a debtor-in-possession approach, the LRC favoured the appointment of a "provisional supervisor"—a qualified insolvency specialist[22]—to take over the running of the company whilst formulating a proposal for a "voluntary arrangement" to be put to the company's creditors. Approval by the creditors, who vote as one single class, requires approval by a majority in number and in excess of two-thirds in value of the creditors.[23] Following the adoption of a voluntary arrangement, management powers would return to the directors, whilst the provisional supervisor would (normally) become the supervisor of the voluntary arrangement, with overall responsibility to ensure compliance with its terms.[24]

Secondly, the provisional supervision regime is not confined to companies that are insolvent or likely to become insolvent; a provisional supervisor may be appointed "whether or not the company is able to pay its debts".[25] Thirdly, a moratorium comes into operation on the "relevant date", i.e. when the provisional supervisor is appointed.[26] Such appointment does not require any court involvement, but occurs upon the filing of the relevant documentation.[27] Fourthly, the moratorium binds all creditors—with the exception of a limited category of secured creditors, called "major creditors"[28]—whose debts were owing prior[29] to the relevant date. Fifthly, the moratorium initially lasts for 30 days, but can be extended for up to six months upon an application by the provisional supervisor to the court.[30] The moratorium cannot be extended by the court beyond six months from the relevant date, although such an extension can be granted by a meeting of the creditors.[31] Finally, the Bill sets a "low threshold" for the appointment of a provisional supervisor, since it requires only that the appointor, which would normally be the board of directors, is satisfied that there is a reasonable

[20] See *supra* n. 10 and accompanying text.

[21] See also JB Bannister, "Staying Alive in Hong Kong: a Comparative Review" (2000) 16 *Insolvency Law and Practice* 17; Booth, *supra* n. 10, 248.

[22] The appointment by the Official Receiver of suitably qualified individuals to a panel of provisional supervisors is contemplated by the Bill (CO, s. 168X).

[23] *Report*, *supra* n. 3, para. 16.37; this is reflected in CO, s. 168ZT(2), (14).

[24] *Report*, *supra* n. 3, paras 16.42–16.44; CO, s. 168ZU.

[25] CO, s. 168Y(2)(a); *Report*, *supra* n. 3, para. 3.9.

[26] CO, s. 168ZD(1); *Report*, *supra* n. 3, para. 5.12.

[27] CO, s. 168ZA; *Report*, *supra* n. 3, para. 6.1.

[28] See, further, *infra* n. 51 and accompanying text.

[29] Debts incurred after the relevant date are expressly *not* subject to the moratorium (CO, s. 168ZD(4)(a)). *Cf* the position under IA 1986, Pt II, where the suspension of creditors' remedies applies to both pre-commencement and post-commencement debts. In Australia, the moratorium applies to any court proceedings against the company (Corporations Law, s. 440D(1)), although a deed of company arrangement is not binding on creditors in respect of claims arising *after* the date the administration commenced (*ibid.*, ss 444D(1), 444A(4)(i)).

[30] CO, s. 168ZE(2); *Report*, *supra* n. 3, paras 5.12–5.17. Individual creditors can at any time apply to the court to be exempted from the moratorium on the basis of "significant financial hardship" (CO, s. 168ZE(4)).

[31] CO, s. 168ZS(2)(a); *Report*, *supra* n. 3, paras 5.32–5.33.

likelihood that a proposal could be made which would achieve one or more of the following purposes:[32]

> "(a) a more advantageous realisation of the company's property than would be effected on a winding up of the company;
> (b) the survival of the company, and the whole or any part of its undertaking, as a going concern; or
> (c) the more advantageous satisfaction, in whole or in part, of the debts and other liabilities of the company . . . "

In particular, the intended provisional supervisor does not have to prepare any preliminary report, nor is there any requirement that the intended provisional supervisor must declare that *he* is satisfied that there is a reasonable prospect of the achievement of one or more of the specified purposes. (The LRC was, perhaps, more concerned about encouraging directors to appoint a provisional supervisor than about over-optimistic assessments as to the prospects of a successful rescue.[33])

2. Criticism and comment

(a) Solvent companies and their shareholders

That a moratorium is initially available without any court intervention, or the preparation of reports by an insolvency practitioner, distinguishes provisional supervision from administration under Part II of the IA 1986. This streamlined procedure should lead to substantial savings in both cost and time.[34] Moreover, as noted above, the Bill contemplates a company going into provisional supervision whether or not it is insolvent or is likely to become insolvent.[35] Yet, the Bill makes no provision for meetings of shareholders. Where a restructuring regime is linked to the insolvency of a company, as, for example, in England (administrations)[36] and Australia (corporate voluntary administrations),[37] it is understandable that shareholders—having little or no tangible interest—are not given the chance to vote down a plan approved by the creditors. But if the regime is available to solvent companies, it is difficult to see why the creditors' meeting should alone determine the outcome. A better course to follow might be the company voluntary administration (CVA) procedure in England—which is not restricted to insolvent companies—under which a proposal must be submitted to both creditors *and*

[32] CO, s. 168Z(1).
[33] The LRC (*Report*, *supra* n. 3, para. 1.39) noted that many companies (including listed companies) in Hong Kong are family owned and run, and that the family might be very reluctant to allow an outsider — such as a provisional supervisor — to assume control.
[34] Bannister, *supra* n. 21, 19.
[35] See *supra* n. 25 and accompanying text.
[36] IA 1986, s. 8(1)(a).
[37] Corporations Law, s. 436A(1)(a).
[38] IA 1986, s. 1(1).

shareholders for approval.[38] Indeed, a "voluntary arrangement" is explained in the Bill as meaning an arrangement providing for either "(i) a composition in satisfaction of the company's debts; or (ii) a scheme of arrangement of the company's affairs".[39] This is, in substance, the same meaning given to the term "voluntary arrangement" in section 1(1) of the IA 1986. The absence from the Bill of any specific procedural safeguards designed to protect shareholders would seem to leave the (minority) shareholders in a vulnerable position.[40]

In short, these commentators would suggest that there is an inherent contradiction in a rescue or restructuring regime which, on the one hand, encompasses schemes of arrangement for solvent companies yet, on the other, excludes shareholder participation in such cases.

(b) *Secured creditors: general rights*

The position under the IA 1986 is that in an administration the interests of secured creditors are given extensive protection.[41] Although the administrator has power to dispose of property which is subject to a floating charge, the chargeholder does not lose its priority in relation to the proceeds of disposal.[42] Where property is subject to a fixed charge, the court may order its disposal, but again without prejudicing the chargeholder's interest in the proceeds of disposal.[43] In relation to a CVA, a proposal which affects the right of a secured creditor to enforce its security cannot be approved at a meeting, except with the concurrence of the creditor concerned.[44] It might be expected, therefore, that broadly similar protection would be given in the Bill to secured creditors in Hong Kong. Yet there is no provision in the Bill that would prevent the creditors' meeting from approving a proposal which directly impairs the rights of secured creditors.[45] Thus, for example, a majority of creditors holding 70% of the corporate debt could approve a proposal that all creditors—secured and unsecured alike—should release 60% of their debt and accept 40% payable by the company over a three-year period. (That in certain instances a minority secured creditor might perhaps be able to petition the court on the basis that his rights were in substance being expropriated by the majority, does not detract from the wider issue of whether secured creditors' pre-existing rights can in general be diluted by a vote in the creditors' meeting.) When

[39] CO, s. 168U.

[40] In theory, a (wealthy) shareholder could bring unfair prejudice proceedings pursuant to CO, s. 168A (a replica of Companies Act 1985, s. 459), since s. 168A is exempted from the moratorium (CO, s. 168ZD(4)(g)). However, the creditors' meeting could well approve a proposal before a shareholder would be in a position to start unfair prejudice proceedings.

[41] It has frequently been argued that English insolvency law overly protects secured creditors. See D Milman and DEM Mond, *Security and Corporate Rescue* (Manchester, Hodgsons, 1999).

[42] IA 1986, s. 15(1), (4).

[43] *Ibid.*, s. 15(2), (5).

[44] *Ibid.*, s. 4(3).

[45] See now the postscript to this paper below for more recent changes.

questions were put to the Government in Hong Kong as to whether, as in the above example, a proposal could be passed against the wishes of a secured creditor requiring all creditors to take a "haircut", the response was that just such a scenario had been contemplated.[16]

The incorporation of such a premise into the provisional supervision regime would have important consequences for bank-lending in Hong Kong. For instance, a bank might take a floating charge, anticipating that in the possible event of a liquidation (or receivership) it would be adequately protected. However, under the Bill, the creditors' meeting might force the bank to take a haircut. As the bank could have no idea when taking its security what the position might be should the borrower go into provisional supervision (perhaps several years later), that risk would have to be factored into the costs of corporate borrowing.

The LRC did not raise the issue of secured creditors being forced to take a haircut. Moreover, there are passages in the *Report* which suggest that the LRC's intention was that no proposal which modified the rights of a secured creditor could be approved unless the secured creditor gave its consent.[17] The undermining of secured creditors' rights to the extent apparently envisaged by the Bill is simply unacceptable, and it is to be hoped that the Government will modify its position so as clearly to protect the position of secured creditors (subject to a limited "cramdown" provision).[18] (See postscript to this paper below).

(c) Secured creditors: veto power

Leaving to one side the general position of secured creditors, there is also an issue concerning the right conferred upon certain secured creditors to veto a provisional supervision.

Under the English administration regime, the holder of a floating charge over the whole or substantially the whole of the company's assets can, in general, appoint an administrative receiver, thereby preventing the making of an administration order.[19] In Australia, the legislation is not restricted to floating charges, and permits the holder of a charge or charges over the whole or substantially the whole of the company's property to proceed with enforcement regardless of the

[16] As part of an exchange of correspondence between P Smart and the Office of the Official Receiver in January and February 2000.

[17] See, e.g. *Report, supra* n. 3, para. 13.17 ("Secured creditors would . . . be protected in that the provisional supervisor could not dispose of secured property without the consent of the secured creditor"). The LRC's initial proposals appeared, if anything, to enhance the position of secured creditors. See Booth, *supra* n. 10.

[18] Whereby a provisional supervisor can demonstrate to the court that a secured creditor's interests would not be discriminated against unfairly and that the secured creditor would receive "fair and equitable" treatment under a rescue plan. These principles are well known in relation to Chapter 11 reorganisations under the US Bankruptcy Code, §1129(b)(1), (2).

[19] IA 1986, s. 9(3).

administration.[50] The Bill requires the provisional supervisor, within three working days of his appointment, to give relevant notice to each of the company's "major creditors".[51] The notice requires the major creditor, within a maximum of seven days from the relevant date, to inform the provisional supervisor whether the creditor consents to the continuation of the provisional supervision.[52] Where a major creditor specifically refuses to consent, the provisional supervision terminates.[53] A major creditor is defined as:

> "the holder of a charge over the whole or substantially the whole of the company's property if, but only if, the claim under the charge amounts to *not less than 33⅓% of the liabilities of the company* before the relevant date."[54]

It is suggested that the reference to 33⅓% of the company's liabilities may at times place an impracticable administrative burden upon a provisional supervisor, in particular when required to ascertain, within three days of his appointment, whether there is one or more "major creditors". For example, where there is a group of companies (some members of which are solvent and some insolvent) and cross-guarantees have been given, the total liabilities of one company within the group may be far from immediately apparent. There will also be instances where a company's accounts are missing, wholly inadequate or even a work of fiction.

The rationale underlying the 33⅓% requirement is presumably that a company may well have granted several charges, particularly floating charges, and a veto should not be given to every chargeholder.[55] However, in terms of principle, this rationale is somewhat lacking, since there is no difference in principle between one secured creditor holding 34% of the corporate debt and another holding 32%. Nor will it be overlooked that a company, shortly before going into provisional supervision, might deliberately allow its total indebtedness to increase so as to dilute a particular secured creditor's "share" from 34% to 32%.[56] Moreover, it is

[50] Corporation Law, s. 441A. See P Crutchfield, *Corporate Voluntary Administration Law* (New South Wales, LBC Information Services, 2nd edn, 1997), 125–31.

[51] CO, s. 168ZQ(1). The Bill contains one exception, which roughly corresponds to IA 1986, s. 245, namely where an insolvent company created the charge in the 12 months prior to the relevant date. See *infra* n. 62.

[52] Where consent is given (or deemed to have been given, see *infra* n. 53) a major creditor is bound by the provisional supervision (CO, s. 168ZQ(3)(b)(ii)).

[53] CO, s. 168ZQ(2)(a). If a major creditor objects but fails to inform the provisional supervisor, the major creditor is treated as having consented (*ibid.*, s. 168ZQ(3)(a)).

[54] *Ibid.*, s. 168ZQ(5) (emphasis added). This requirement has recently been removed. See postscript to this paper below.

[55] *Report, supra* n. 3, paras 13, 14.

[56] These commentators would suggest that giving a veto to a secured creditor holding 33⅓% or more of the company's debt is unnecessary. Since a secured creditor can vote without having to give up his security (*Report, supra* n. 3, para. 16.36), one-third of the company's total debt would be sufficient to block any proposal at the creditors' meeting. The LRC did not specify any particular percentage, but merely referred to a "holder of any charge over the whole or substantially the whole of a company's assets, whose level of exposure or lending would warrant such an extensive charge" (*ibid.*, para. 13.8).

doubtful whether a reference to a specified percentage of total indebtedness would, in fact, prevent (well-advised) lenders from obtaining a veto, since a lender might require that any loan be made to a special purpose subsidiary company, to which essential assets had been transferred.[57] In addition, in many instances, a director's potential personal liability under a bank guarantee might function just as effectively as a statutory veto.[58]

These commentators would suggest that the 33⅓% (or indeed any other percentage) requirement is ill-conceived.

(d) Creditors, management and connected persons

A statutory corporate rescue regime, like any other insolvency procedure, seeks to strike a balance between the various and often competing interests that will be present in any given case. These commentators' view is that in two particular areas the Bill appears overly to favour management to the detriment of ordinary creditors. The first deals with voting; the second concerns avoidance powers.

Under the IA 1986, in relation to both administrations and CVAs, a resolution at a creditors' meeting will be invalid if a majority of independent creditors vote against it.[59] Specific protection for non-associated creditors is also available under the Australian legislation.[60] However, there is no such protection under the Bill[61] (perhaps because the LRC did not address this issue).

In addition, both the *Report* and the Bill are silent as to the ability of the provisional supervisor to avoid transactions, such as unfair preferences, transactions at an undervalue, or extortionate credit transactions.[62] In comparison, under the IA 1986 the full range of avoidance powers is conferred upon an administrator.[63] It is otherwise in relation to a CVA, yet the directors, when making their initial proposal, must include details of, first, whether there are any circumstances giving rise to the *possibility*, in the event that the company should go into liquidation, of avoidable transactions, and, secondly, whether (and if so, how) it is proposed under the

[57] Thus, as far as the subsidiary is concerned, the bank would be a "major creditor" and have a veto. Additionally, as essential assets are owned by the subsidiary, the parent cannot be rescued unless the subsidiary is part of the plan.

[58] The Bill does not contain a provision suspending the enforcement of directors' guarantees during the period of provisional supervision. *Cf* Corporations Law, s. 440J(1).

[59] Insolvency Rules 1986 (SI 1986/1925), r. 1.19(4)(c) (CVA) and r. 2.28(1A) (administration). See now postscript to this paper below.

[60] Corporations Law, s. 600A; and see Crutchfield, *supra* n. 50, 246–7.

[61] Whether the court could intervene – perhaps on the basis that the majority was not acting in good faith – is problematic, since approval of a proposal is not a matter for the court and there is no general "unfair prejudice" remedy available to *creditors* under the Bill (*cf* IA 1986, ss 6, 27).

[62] *Report, supra* n. 3, para. 13.19 did recommend that either a fixed or floating charge created within 12 months of the provisional supervision by an insolvent company should be invalid, except to the amount of any cash paid to the company at the time of or subsequently to the creation of the charge. See CO, s. 168ZQ(4), which approximately corresponds to IA 1986, s. 245.

[63] See IA 1986, ss 238–41, 244–5.

voluntary arrangement to make provision indemnifying the company in respect of such claims.[64] Accordingly, from the very outset, the existence of any prior transactions which may *possibly* be impeached must be revealed.[65] In Australia, although the avoidance powers applicable in a liquidation are not available in a corporate voluntary administration,[66] the administrator, in his report to creditors, must specify whether, in his opinion, the company has entered into any transactions which would appear to be liable to be avoided should the company go into liquidation.[67] An administrator is also under a duty, *inter alia*, to report any relevant misapplication of the company's property, breach of duty, default or negligence.[68]

Although the LRC did not specifically address the question of avoidance powers, it is these commentators' understanding that the LRC considered that the presence of avoidance powers would be a disincentive for directors when deciding whether or not to initiate provisional supervision; and, in addition, that it might be difficult to exercise avoidance powers within the relatively short time-period contemplated for provisional supervision. Two observations may, perhaps, be made. First, the availability of avoidance powers would be of little concern to an honest director. Secondly, although an avoidance action could not realistically be completed within the relatively short time-period envisaged for provisional supervision, the availability of such powers would change the relative bargaining strengths of the parties. In short, whether or not a full range of avoidance powers is ultimately made available under the provisional supervision regime, at the very least significant disclosure and reporting requirements should be specified in the legislation. Otherwise, provisional supervision may be seen by creditors as providing an easy opportunity for management to sweep past irregularities under the carpet.[69]

[64] Insolvency Rules 1986, r. 1.3(2)(c)(iii).

[65] Hence, it has been stated that "creditors would want very specific assurances that any monies which have been unfairly disbursed by the company will be recovered by the supervisor for the general body of unsecured creditors. Certainly the creditors will not agree to preferences, undervalues, etc. being forgotten when such transactions could be vigorously attacked by a liquidator in a winding-up situation" (PG Eades, *Insolvency: A Practical Legal Handbook for Managers* (Cambridge, Gresham Books, 1996), 113).

[66] BH McPherson, *The Law of Company Liquidation* (New South Wales, LBS Information Services, 4th edn, 1999), 10.

[67] Corporations Regulations (Cth), r. 5.3A.02. See also Crutchfield, *supra* n. 50, 99–101.

[68] Corporations Law, s. 438D.

[69] This issue has now been addressed in the Companies (Corporate Rescue) Bill 2001; see postscript to this paper below.

[70] See, e.g. E Yiu, "New law protects laid off workers", *South China Morning Post*, 4 June 1999; S Yeung," Legislators question merits of wages plan", *South China Morning Post*, 23 February 2000; J Moir, " 'Unworkable' rescue bill bounces back into Legco", *South China Morning Post*, 6 February 2001.

C. Workers' wages

Broader public debate in Hong Kong on the Bill has largely focused on the issue of workers' wages.[70] The Bill startlingly proposes that, before a company can even go into provisional supervision, it must have either actually paid off all outstanding sums owing to its workers (pursuant to the Employment Ordinance)[71] or established a trust account containing sufficient funds to satisfy those debts.

Where a company is insolvent and a winding-up petition has been presented in Hong Kong,[72] employees who are owed wages and other entitlements can apply to the Protection of Wages on Insolvency Fund (PWIF) for *ex gratia* payments up to specified amounts.[73] (The PWIF was to some extent modelled on the UK National Insurance Fund,[74] although it is funded by a fixed levy on businesses registering in Hong Kong rather than by employees' contributions.) The *Report* proposed that the onset of provisional supervision should trigger the operation of the PWIF.[75] However, concerns were subsequently expressed that unscrupulous employers might lay off their employees without paying them their entitlements and then put the company into provisional supervision, thereby passing the burden of unpaid wages, severance and other payments onto the PWIF.[76] It may be noted that in the financial year 1997–98 the PWIF recorded its first ever deficit (HK$25 million), as the number of claims by employees increased by more than 60% over the previous year.[77] The Government's estimate[78] was that there would be deficits of HK$160 million in 1998–99, HK$114 million in 1999–2000, and HK$108 million in 2000–01. There was concern in certain quarters as to the

[71] Cap 57, LHK. Such sums would include wages and severance payments. The latter can be substantial and would typically be about HK$30,000 (£2,500) for a worker with two years' service, rising to HK$300,000 (£25,000) for a worker with 20 years' service.

[72] Protection of Wages on Insolvency Ordinance (Cap 380), LHK, s. 16(1)(b).

[73] Two points may be noted. First, the fact that an insolvent company has gone into creditors' voluntary liquidation or receivership does *not* trigger the operation of the PWIF, since s. 16(1)(b) refers only to the presentation of a winding-up petition. In respect of a creditors' voluntary liquidation, employees have preferential status (CO, s. 265) and, where a receiver is appointed by a floating charge holder, employees have a similar preferential status (*ibid.*, s. 79). Secondly, however, the limits under the PWIF are far higher than the limits applicable to workers' preferential claims under the CO. For example, under the PWIF up to HK$36,000 may be claimed for unpaid wages; the amount of the corresponding preferential debt under the CO is only HK$8,000 (s. 265(1B)). As a consequence, workers often present a winding-up petition (having first obtained legal aid) even though a creditors' voluntary liquidation is already in progress. See *Re Rena Gabriel HK Ltd* [1995] 2 HKC 273.

[74] See now the Employment Rights Act 1996, s. 184.

[75] *Report*, *supra* n. 3, para 5.42.

[76] K Cooper, "Authorities fear exploitation of workers aid fund", *South China Morning Post*, 22 December 1998.

[77] *Annual Report of the Protection of Wages on Insolvency Fund Board 1997–98*, 5.

[78] *Hong Kong Hansard*, 3 February 1999 (see <http://www.legco.gov.hk/yr98-99/english/counmtg/hansard/990203fc.htm>). In fact, the *Annual Report of the Protection of Wages on Insolvency Fund Board 1998–99*, 3, reveals a HK$185.3 million deficit for 1998–99.

potential insolvency of the PWIF. Following a consultation exercise,[79] the Bill was drafted so that the appointment of a provisional supervisor could not come into effect until the appointor had filed an affidavit stating that the company either: (a) had opened a trust account (with a bank) containing sufficient funds to discharge "all debts and liabilities" to its employees arising under the Employment Ordinance; or (b) had actually discharged all such liabilities.[80] These commentators know of no other jurisdiction in which the treatment of outstanding workers' wages creates such an obstacle to the promotion of any attempted rescue.

Moreover, banks might well be unwilling to lend additional sums to a company, since the money would go straight to the workers rather than actually assisting in re-financing the company. In addition, a company contemplating provisional supervision might be tempted to stop making any effort to pay its trade creditors, and hoard as much cash as possible in order to accumulate a sufficient lump sum to pay off its workers. It is fair to say that the Bill encourages what, in other circumstances, would be condemned as a preference.[81] More importantly, as drafted, the Bill produces inconsistency. Where an insolvent company is wound up, the workers can look to the PWIF for payment only up to specified maximum amounts;[82] but were that very same company to go into provisional supervision, "all debts and liabilities" owed to the workers would have to be discharged. (In other words, the "relative value" of workers' claims will be distorted upon the decision whether to go into provisional supervision or to liquidate.[83]) Finally, although the reference to "all debts and liabilities" might appear to protect workers, in practice the opposite might often be the case; if a company cannot pay off its workers in full, liquidation may be the only alternative.

In the Hong Kong Legislative Council, the Bills Committee identified the treatment of workers' wages as an issue of major concern.[84] The Committee pointed out that, as drafted, the Bill did not permit of any flexibility, so that even if a company's workers consented, the company could not pay them less than 100% of their statutory entitlements, whilst at the same time providing some other consideration (such as stock options). The Bills Committee recommended the "early resubmission" of the corporate rescue proposals to the incoming Legislative Council and, in the meantime, suggested that: "the Administration should meet

[79] *Consultation Paper on Corporate Rescue and the Protection of Wages on Insolvency Fund (Treatment of Employees in "Provisional Supervision")*, February 1999; available at <http://www.info.gov.hk/fsb/consult/index.htm>.

[80] CO, s. 168ZA(c)(iv). See postscript to this paper below.

[81] The CO contains a provision on preferences (s. 266B) which is closely related to IA 1986, s. 239.

[82] See *supra* n. 73.

[83] For an extensive discussion of "relative values", see TH Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, Harvard University Press, 1986), 29.

[84] *Report of the Bills Committee on the Companies (Amendment) Bill 2000 to House Committee Meeting on 9 June 2000* (Legislative Council Paper, CB(1) 1779/99–00), 4, available at <http://legco.gov.hk/yr99-00/english/bc/bc06/reports/bc06_rpt.htm>.

with various professional bodies . . . so that the proposals can be fine-tuned".[85] Whether the Committee was of the view that the treatment of workers' wages merely needed some fine-tuning, so that some flexibility might be permitted, or that a thorough overhaul was required, is not apparent.

These commentators would suggest that in relation to outstanding wages and other entitlements, workers should generally be no better or worse off where a company goes into provisional supervision than they would have been were the company to have been liquidated. The Bill presently breaches this simple proposition.[86] Moreover, even if fine-tuned to allow for some flexibility (so that workers might agree to accept less than 100% of their debts), this principle would still be breached.[87] Instead, the revised legislation might be drafted so as to contain three elements.

(1) The notion of "employees' protected debts"[88] should be introduced. This term would be defined so as precisely to track the various amounts that may be claimed at present from the PWIF upon winding-up.
(2) Every proposal for a voluntary arrangement should be required to contain a provision to the effect that any outstanding employees' protected debts will be immediately satisfied in cash upon the voluntary arrangement coming into effect (the only exception would be where an employee has waived this right in writing).
(3) The court shall not extend the moratorium beyond the initial 30-day period, unless either:
    (a) the provisional supervisor undertakes that, within seven days of the court granting the extension, all the employees' protected debts will be paid off; or
    (b) the court is satisfied that other arrangements have been agreed in writing between the provisional supervisor and the employees that adequately protect the interests of the latter.

A rough outline of the manner in which these suggestions might work in practice is as follows. First, provisional supervision could be initiated, and the moratorium come into effect, *without* any payments being made "up front" to the workers. Secondly, where the provisional supervision collapses within the 30-day moratorium period,[89] the company will go into liquidation and the workers may claim from the PWIF in the normal way. Thirdly, if, however, a plan for a voluntary

[85] *Ibid.*, 5. The legislation has recently been reintroduced as the Companies (Corporate Rescue) Bill 2001 (see postscript below), but no significant change has been put forward in this particular area.
[86] As workers might well recover significantly more upon the company going into provisional supervision than they would if the company were to go into liquidation.
[87] Flexibility would in no way reduce the disparity between workers' entitlements in provisional supervision and in liquidation.
[88] Or some other similar expression.
[89] As would often be the case.

arrangement is approved within the 30-day period, the terms of the arrangement must provide for the immediate payment (in priority to everything else) of the employees' protected debts. Finally, where the provisional supervisor requires an extension of the moratorium, the court will grant an extension only upon the condition that, unless the workers have agreed otherwise, the employees' protected debts are paid within seven days of the court's order.

D. Conclusion

These commentators would respectfully submit that the reasoning underlying the proposed provisional supervision regime is fundamentally sound. In Hong Kong, where even in an economic downturn professional fees are as high as anywhere in the world,[90] it is appropriate that a moratorium may initially be obtained without the preparation of a detailed report or resort to the courts. At present, in relation to both informal workouts and the Hong Kong Approach to Corporate Difficulties, even where most creditors support a restructuring plan, one or two obstinate creditors can seriously prejudice the prospects of a successful rescue. A major advantage that would immediately flow from the enactment of the provisional supervision regime is that the very possibility of putting a company into provisional supervision—and activating the moratorium—will give cause to the obstinate creditor to think again. It is in this context that the treatment of workers' wages under the Bill is most disappointing. Not only is the treatment of workers' wages inequitable, but the Bill also creates a major and unnecessary obstacle to the commencement of provisional supervision. Another significant flaw in the Bill concerns the possibility of forcing a "haircut" upon secured creditors. The procedures proposed in the Bill are also deficient in relation to the complete exclusion of shareholders from the provisional supervision process, the inclusion of a percentage of debt requirement in the definition of a major creditor, the lack of any specific restriction on the power of connected creditors when voting at creditors' meetings, and the failure to tackle the question of avoidable transactions. It is sincerely to be hoped that these issues will be addressed in redrafted legislation over the course of the next 12 months or, in any event, well in advance of the region's next financial crisis.

Postscript

In May 2001 the Hong Kong Government gazetted revised legislation. This time, rather than taking the form of an amendment to the Companies Ordinance, the

[90] There have been several, recent, high-profile insolvencies where Hong Kong judges have expressed disquiet over the level of lawyers' and accountants' fees. See, e.g. *Re Peregrine Investment Holdings Ltd* [1998] 2 HKLRD 670; *Re Peregrine Investment Holdings Ltd and others* [1999] 3 HKLRD 59, CA; *Re Peregrine Investment Holdings Ltd (No. 5)* [2000] 1 HKLRD 157.

proposals are contained in a separate piece of legislation—the Companies (Corporate Rescue) Bill 2001.[91] This new Bill closely follows the form and content of the previous Bill, subject to changes in two main areas. First, in relation to secured creditors, the new Bill expressly prevents the creditors' meeting from voting to modify the rights of a secured creditor, except where that creditor has given consent.[92] The new Bill also removes the reference to 33⅓% of the total corporate debt when defining the term "major secured creditor".[93] Secondly, the new Bill has also addressed these commentators' concerns with reference to connected creditors as well as to avoidable transactions. A resolution at the creditors' meeting will not pass if a majority of independent creditors has voted against it;[94] and the provisional supervisor is placed under a specific duty to investigate transactions which might have been avoided if the company had gone into liquidation.[95]

More importantly, however, the basic approach to the key issue of workers' wages has not been changed in the new Bill. It is still required that all debts and liabilities under the Employment Ordinance owing to a company's employees and former employees must be paid off in full (or a trust account opened) before the company may go into provisional supervision.[96] In short, unless and until the "all debts and liabilities" approach to workers' wages is abandoned, it would appear that the Government's commitment to promoting a "rescue culture" in Hong Kong is half-hearted.

[91] *Hong Kong Government Gazette*, Legal Supplement No. 3, C615 (18 May 2001).
[92] Companies (Corporate Rescue) Bill 2001, s. 23(1).
[93] *Ibid.*, s. 19(5).
[94] *Ibid.*, Seventh Schedule, para. 23.
[95] *Ibid.*, Fourth Schedule, para. 2.
[96] *Ibid.*, Second Schedule, para. 3(d).