

Submissions by the Law Society of Hong Kong on the Companies (Corporate Rescue) Bill

The Law Society of Hong Kong's Insolvency Law Committee has considered the Companies (Corporate Rescue) Bill 2001 which has similar provisions as those proposed in the Companies Bill 2000. The Law Society's views on that proposed legislation were incorporated in our comments dated 20 March 2000.

In commenting on the current draft legislation the committee has focused on issues which appear to be most likely to affect the use and effectiveness of the Provisional Supervision procedure (and hence the availability of a workout mechanism with the protection of a moratorium in Hong Kong).

The need for a corporate rescue procedure which permits company workouts to occur under the management and control of independent third party while the company is protected from creditor actions has long been recognised as a deficiency in Hong Kong's corporate insolvency law.

The new Bill goes somewhat towards meeting this need. However, for the reasons set out below, there is doubt that the procedure, if implemented, will in practice be widely used. The key factor in this assessment is the operation of the proposed Section 16.

Section 16 - Liability for certain contracts of employment

Section 16 is not particularly easy to interpret. However, in summary, it appears to propose the following:

- (a) The independent provisional supervisor ("PS") is deemed to be personally liable for "wages, salaries and other entitlements" under contracts of employment that existed before the "relevant date" (the date the provisional supervision commences) if the liability under the contract is accepted in writing by the PS within 14 days or alternatively, if the PS chooses to employ the persons concerned after the relevant date. (Section 16(1)(a)&(b))
- (b) If the PS does not accept or specifically terminate the contract of employment it is deemed to be determined 14 days after the relevant date. (Section 16(2)(a))
- (c) If the contract is terminated or deemed to be terminated in those circumstances, then "the wages, salaries and other entitlements" under the relevant employment contracts are deemed to be liabilities of the company that were incurred on or after the relevant date and are then charged against and are required to be paid out of the property of the company by the PS in the same priority as "qualifying liabilities". (Section 16(2)(b)(i) & (ii)).

- (d) A liability under a contract of employment existing at or incurred after the relevant date is deemed to be a “qualifying liability” if it involves the payment of wages or salaries or a contribution to an occupational scheme or a provident fund scheme. (Section 16(4))
- (e) A “qualifying liability” of this type is charged against and required to be paid out of the property of the company in priority (apart from fixed charges) to the indemnity given to the provisional supervisor in respect of the liabilities incurred in the discharge of his duties and his own remuneration and the costs and charges of the provisional supervision process. These would normally have priority over all other claims (apart from fixed charges). (Section 16(3))

In effect, therefore, liabilities under existing contracts of employment, even if not accepted by a provisional supervisor, are charged against the property of the company in priority to all other liabilities apart from fixed charges. They also rank ahead of the costs of conducting the provisional supervision.

In addition, Schedule 2(3)(d) to the Bill contemplates that a PS will make an affidavit to be filed with the Official Receiver, the Registrar and High Court Registry pursuant to Section 8. This affidavit is required to record that the company has a “trust” account, the purpose of which is (inter alia) to pay all liabilities under the Employment Ordinance by the company to its former employees before the relevant date. Section 8 of the Bill contemplates that the filing of this affidavit (and hence the establishment and funding of the trust account) is a prerequisite to the appointment of the PS and the commencement of any moratorium.

It therefore appears that these liabilities are protected by a charge in respect of company assets and also a requirement that financial provision be made in the form of a trust account. In the latter respect this is a prerequisite to the commencement of the provisional supervision process.

The society has previously commented on this issue in the context of Section 168(zk) of the Companies (Amendment) Bill 2000. In summary, our views are that the requirements in respect of wages, salaries and other entitlements in the circumstances of a company workout, where the asset and liability position is likely to be unclear and creditor support often essential, are likely to result in the provisional supervision being not widely used.

The reasons for this view are as follows:

1. Many of the companies that would normally seek the benefit of provisional supervision and the moratorium are likely to be at the point where they are in effect insolvent and/or have little in the way of funds or assets.
2. Troubled companies tend to maintain poor or incomplete records. It often takes weeks or more often months to assess their true financial position.

3. The uncertainty about the financial position of such companies often means that their survival in a workout is not certain and, at least in principle, support is required from banks and other creditors in order for the workout to proceed. In deciding whether to support, most banks and creditors wish to make an assessment of the viability of the business concerned and also to assess whether or not activities of the provisional supervisor are likely to produce a positive result. In practice, banks and creditors tend only to commit to support on a limited and gradual basis as the true position of the company and its business is assessed and it continues to have an apparent viable future.
4. In these circumstances it would be unusual for creditors to be willing or able to make an assessment and commit to support within 14 days. It therefore seems unlikely that there would be many situations where the provisional supervisor would consider prudent to retain existing staff. As a result staff members who may be key employees in a future re-organised business are likely to be lost.
5. The fact that outstanding wages and salaries would have to be provided for in a trust account means that cash sum has to be available at the outset. Typically this would involve the need for creditor advances before even embarking on the Provisional Supervision process. This is likely to operate as a disincentive to use the procedure in many cases. The inability to assess the existence and value of company assets capable of meeting the charge under Section 16 at this early stage would exacerbate this problem.
6. Effectively, creditors who might be inclined to support provisional supervision and a workout during a moratorium, are likely to also be required to fund this liability at the outset. They would have to be prepared to do so without any certainty that the provisional supervision will ultimately have assets to meet this liability or produce any positive result in terms of reestablishing a viable business capable of meeting its liabilities.

It is difficult to generalise about the nature of company workouts and the attitude of creditors. However, the view is that the present provisions are likely to cause larger creditors to see the provisional supervision procedure as an option only to be used where there is both reliable financial information about the business in question and a relatively strong corporate asset position. In practice, this tends to be the case infrequently.

Conclusion

Obviously, legislation involving a moratorium to provide protection to companies with viable businesses in the course of workouts is long overdue in Hong Kong. What is currently proposed is an improvement on the present system. This relies on informal arrangements or the use of winding up petitions and the appointment of provisional liquidators as a way of obtaining protection and is complicated and expensive. However, the issues referred to above seem likely to lead to a situation where the use of the Provisional Supervision procedure will be limited to companies and businesses where there is reliable financial information and available assets at the very outset of the process. This is relatively rare situation. In our view Provisional Supervision is therefore unlikely to be extensively used. This would be most unfortunate given the time and



effort invested over a period of years in trying to develop a workable corporate rescue regime in Hong Kong.

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