LC Paper No. CB(1)2029/00-01

Summary of concerns
of the Bills Committee on Companies (Amendment) Bill 2000

Background

At present, Hong Kong companies that run into financial difficulty may try to come to an arrangement with their creditors by means of a non-statutory arrangement or by means of the arrangement and reconstruction provisions under section 166 of the Companies Ordinance (Cap. 32). However, there is nothing in section 166 to prevent a creditor from presenting a petition to wind up the company, an event which could have the effect of terminating an arrangement being formulated. The Law Reform Commission (LRC) considers that the major deficiency of section 166 is the lack of a moratorium that can bind creditors while an arrangement plan is being formulated.

2. The LRC then recommended in its "Report on Corporate Rescue and Insolvent Trading" in 1996 the introduction of a statutory corporate rescue procedure in Hong Kong whereby a ***moratorium*** on legal action would be provided to a company in financial difficulty. The moratorium would enable the company to appoint an independent third party, the ***provisional supervisor***, to try to work out a ***voluntary arrangement*** with the company's creditors. Such procedure would assist businesses in financial difficulty to turn around and continue to operate as going concerns.

3. In relation to the introduction of a corporate rescue procedure, the LRC has also recommended that directors and senior management, collectively known as "***responsible persons***", should be liable to pay compensation to the company if they are found by the court to have failed in their respective duties by permitting the company to trade while insolvent. The LRC considers that the “***insolvent trading***” provisions will encourage directors and senior management to face the fact that a company is slipping into insolvency and cause them to address the situation rather than to trade on regardless of the consequences.

4. The legislative proposals to implement the LRC's recommendations formed part of the Companies (Amendment) Bill 2000, which was introduced into the Legislative Council in January 2000.

General views of the Bills Committee

5. The Bills Committee on Companies (Amendment) Bill 2000 (the Bills Committee) recognized that the proposed legal framework for implementing a corporate rescue procedure was an important piece of legislation which might help

companies in financial difficulty to turn around. The Bills Committee did not dispute the need and potential benefits of the corporate rescue and insolvent trading proposals.

6. However, the Bills Committee noted that the introduction of a moratorium to protect the debtor company from creditor actions and the taking over of the control of the company during the moratorium by a provisional supervisor might affect the competing interests of the various parties involved, such as the company, the creditors (secured and unsecured), the employees and the shareholders. As such, the Bills Committee saw the need to ensure that the proposals were generally acceptable to the general public, especially to those parties whose interests would be affected by the proposals. As views from various professional bodies were only available in mid/late April 2000 and their submissions contained substantive comments on and criticisms of the proposals, the Bills Committee decided not to proceed with the examination of the corporate rescue and insolvent trading proposals within the limited time available before the end of the term on 30 June 2000.

Major concern of the Bills Committee

7. The Bills Committee expressed concern about the practical applications of the proposed corporate rescue procedure and raised the following points:

(a) Whether a financially-troubled company was able to set aside sufficient funds to settle all arrears of wages, severance pay and other statutory entitlements of its employees as if it were a going concern, before initiating the corporate rescue procedure;

(b) The Companies (Amendment) Bill 2000 did not provide for any flexibility in respect of the requirement on a company to settle all outstanding claims from employees before the relevant date. The effect was that even if the employees concerned were willing to give up their legal rights to assist the company to turn around in return for some other considerations granted by the company, for example, the allotment of stock options, it was, legally speaking, not permitted under the proposed provisions; and

(c) Under the Companies (Amendment) Bill 2000, there were situations where the moratorium should not be applied such as fresh debt incurred by the company during provisional supervision or whenever an exemption was granted by the court for creditor suffering from significant financial hardship. However, there was nothing in the proposal to prevent a creditor from presenting a petition to wind up the company which would effectively defeat the purpose of having a corporate rescue procedure to help a financially-troubled company to turn around.

Issues for further examination

8. The Bills Committee also identified the following issues which would require further examination in future:

(a) The need to balance and safeguard the interests of the various parties involved, such as the company, the creditors (secured and unsecured), the employees and the shareholders before initiating the moratorium and during the provisional supervision;

(b) The appointment of provisional supervisor and the subsequent monitoring and control mechanism, bearing in mind he would be indemnified out of the assets of a company and the possibility that he might be allowed to turn into a provisional liquidator of the company when he was unable to formulate a plan to the satisfaction of the creditors during the moratorium;

(c) The involvement of the court in the extension of the moratorium for the initial six months from the commencement of the moratorium but not for the period thereafter; and

(d) The potential conflict between a provisional supervisor and the directors of a company as the former would be empowered to manage and control the company and had the right to retain or dismiss directors of the company, and the statutory defence available to directors and senior management for insolvent trading.

Recent developments

9. Based on the Bills Committee's comments, the Administration developed a proposal to provide for flexibility on the settlement of outstanding wages and other entitlements of employees, and consulted the Labour Advisory Board (LAB) and Protection of Wages on Insolvency Fund Board (PWIFB) on the proposal in November/December 2000. Having regard to the objections raised by the LAB and PWIFB, the Administration decided not to pursue the flexibility proposal put forward by the Bills Committee. The Administration maintained the original proposal as follows:

(a) The appointment of a provisional supervisor of the company should not come into effect unless and until, among others, an affidavit has been filed with the Official Receiver and the court confirming that either the company has no debts and liabilities owing by virtue of the Employment Ordinance (Cap. 57) to its employees or former employees; or that the company has a trust account, the exclusive purpose of which is to provide funds to pay all debts and liabilities due and owing by the company to its employees and former employees before the commencement of the corporate rescue procedure ***(Schedule 2 of the Companies (Corporate Rescue) Bill)***; and

(b) As regards employees who continued to be employed or were newly employed by the provisional supervisor after the commencement of the corporate rescue procedure, the company as well as the provisional supervisor personally should be liable for such employees' wages and other statutory entitlements that the company might owe to them. Where a contract of employment was not accepted or was terminated by the provisional supervisor after the commencement of the corporate rescue procedure, any outstanding wages, salaries and other emoluments under the contract would be regarded as the liabilities of the company and would be charged on and paid out of the property of the company by the provisional supervisor ***(Clause 16 of the Companies (Corporate Rescue) Bill)***.

10. On 5 February 2001, the Administration briefed the LegCo Panel on Financial Affairs on the outcome of its consultation. The relevant papers are attached:

(a) An extract from the minutes of the meeting of the Panel on Financial Affairs on 5 February 2001 (***LC Paper No. CB(1)1757/00-01(02)***); and

(b) Paper provided by the Administration (***LC Paper No. CB(1)522/00-01(03)***).

<u>Legislative Council Secretariat</u>
21 September 2001

LC Paper No. CB(1)1757/00-01(02)

Extract from minutes of meeting
of the LegCo Panel on Financial Affairs held on 5 February 2001

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IV Statutory Corporate Rescue Procedure
(LC Paper No. CB(1) 522/00-01(03))

7. The Deputy Secretary for Financial Services (DS/FS) introduced the information paper. She said that the Law Reform Commission (LRC) recommended in 1996 the introduction of a statutory corporate rescue procedure in Hong Kong with a view to assisting companies in financial difficulties to turn around and continue to operate as going concerns. Such procedure involved the appointment of a provisional supervisor (PS) for the company concerned to try to work out a voluntary arrangement with its creditors. A moratorium on legal action would be imposed upon the commencement of the corporate rescue process to prevent the company from being wound up. LRC's recommendation of using the Protection of Wages on Insolvency Fund (PWIF) to meet the outstanding arrears in wages and other statutory entitlements owed to its employees by a company undergoing corporate rescue was not accepted by PWIF Board and the Labour Advisory Board (LAB). The Administration hence adopted the approach of requiring a company to clear all outstanding claims of its employees before it could initiate the corporate rescue procedure. The legislative proposals on corporate rescue were introduced into the Legislative Council (LegCo) in January 2000 as part of the Companies (Amendment) Bill 2000 (the Bill). The Bills Committee scrutinizing the Bill expressed doubts on the viability of the proposed requirement to settle all arrears due and owing by the company to its employees and recommended that the draft provisions on corporate rescue should be excised from the Bill and be deferred for re-submission to LegCo at a later stage. It also suggested that the Administration should consult the PWIF Board and LAB on its proposal of providing some flexibility to the requirement. Both organizations were opposed to the flexibility proposals subsequently put forward by the Administration as set out in paragraphs 15 to 22 of the paper. Having regard to the objections of the PWIF Board and LAB and balancing the interest of all the relevant parties, the Administration decided to maintain the original proposal of requiring a company to settle all debts and liabilities it owed to its employees before the start of the rescue procedure. Separately, in the light of comments made by professional bodies and trade organizations, some of the provisions on corporate rescue would be modified. The Administration intended to re-introduce the legislative proposal on corporate rescue into LegCo within the current legislative session.

8. In reply to enquiries about details of the proposed corporate rescue procedure, the Assistant Official Receiver (Legal Services 2) advised that the initial moratorium period would be of 30 days within which a PS had to formulate a voluntary arrangement proposal for consideration of creditors at a creditors' meeting. The period could be extended by a maximum of six months with the approval of the court. Further extension beyond six months would be subject to the agreement of creditors. In order to ensure that a company initiating a corporate rescue could settle all debts and liabilities owed to its employees and that the commencement of the procedure would not be delayed, the company concerned could set up a trust account exclusively for this purpose whereby the PS would make the necessary payments from the account to employees after the commencement of the procedure. As the PS would have to carry out a large number of tasks once he took office, the timeframe within which he had to make the payment should not be rigidly fixed by the law so as to provide him with some flexibility. There would however be provisions requiring a PS to make payments to employees prior to the convening of the creditors' meeting without regard to the outcome of the voluntary arrangement proposal. It was not envisaged that PS would deliberately delay payments to employees.

9. Mr SIN Chung-kai conveyed the support of the Democratic Party for an early introduction of a statutory corporate rescue procedure in Hong Kong. He further opined that it was necessary to enhance corporate governance in Hong Kong for the successful implementation of such procedure. Mr LEE Cheuk-yan welcomed the requirement for a company to settle all debts and liabilities owed to its employees before it could start the rescue operation as this would protect the benefits of employees. He pointed out that as a company could offset some of the statutory entitlements for employees with its contributions already made to occupational retirement schemes or the Mandatory Provident Fund schemes, the requirement should not increase the financial burden on the company. While expressing support for a statutory corporate rescue procedure, Mr Eric LI was disappointed about the result of the consultation. He remarked that a similar requirement did not exist in other jurisdictions and expressed concern that in the absence of some flexibility in the requirement, the success of the proposed rescue procedure would be undermined. He asked whether the Government would consider setting up a "corporate rescue fund" to assist companies in financial difficulties in undertaking rescue schemes.

10. Recognizing that there were limitations in the proposed corporate rescue procedure, DS/FS said that it would be the first step to improve the existing voluntary procedure and provide a meaningful statutory option for viable businesses to continue to operate. The proposal would also enable practitioners to make a start in building up the required expertise and experience. On the proposal of establishing a government "corporate rescue fund", DS/FS cautioned that it would be inappropriate to use public money to bail out companies in financial difficulties. She said that there was no similar arrangement in overseas jurisdictions which had statutory corporate rescue procedures in place.

11. Noting that unsecured creditors would not be given the option to elect whether to participate in a proposed rescue operation but would be bound by the moratorium and the terms of a voluntary arrangement that might be eventually drawn up under the rescue operation, some members expressed concern that there was inadequate protection for the rights of unsecured creditors. Mr James TIEN was concerned that in the event that a rescue operation was dragged on over a number of years and became unsuccessful in the end, unsecured creditors might end up recovering less payment than what they could get under the liquidation of the company.

12. In response, the Official Receiver (OR) clarified that under the original proposal, only major secured creditors, i.e. those holding the whole or substantially the whole of the company's property as security with $33^1/_3\%$ or more of the outstanding liabilities of a company, would be given the option to elect to participate in a proposed rescue or abstain from it by relying on their securities. Other minor secured creditors were not accorded the same treatment. Such proposal had been incorporated in the Bill. In view of the concern expressed that the arrangement was inconsistent with the long established secured lending practice where secured creditors, be they large or small, could not be forced to accept any "hair-cut" of debts without their consent, the Administration proposed to modify the procedure so that the existing rights of the secured creditors would remain unaffected. As such, all secured creditors, major or minor ones, would have the right to elect whether to participate in the provisional supervision of the concerned company. Their rights could not and would not be affected by the proposed voluntary arrangement except with their concurrence.

13. As regards protection for the rights of unsecured creditors, OR clarified that the proposed corporate rescue procedure would not jeopardize the rights that they were entitled to under the existing insolvency procedure. Under the existing insolvency regime, it was also the major secured creditors who held the veto power in respect of financial arrangements in the liquidation process of a company. There would be an additional safeguard for the interest of all creditors in the legislative proposal. A creditor who could prove to the satisfaction of the court that the moratorium had caused significant financial hardship on him would be exempted from the moratorium and any voluntary arrangement.

14. In this connection, Mr Eric LI remarked that experience revealed that very often little assets would be left to unsecured creditors in a liquidation of a company. Despite its limitations, the professionals concerned were supportive of the principle of a corporate rescue procedure recognizing that it would offer more benefits to a company in financial difficulties and its creditors than that of a liquidation procedure.

15. Noting that a PS would be vested with extensive power in undertaking a rescue operation, such as deciding whether a company was viable and hence worth rescuing, and laying off employees, some members opined that adequate check and balances should be put in place to ensure the professional standard and proper performance of PS.

16. OR said that the Administration recognized the important role of PS. The duties, rights and liabilities of a PS would be clearly stipulated in the law. A PS would have clear duty of care and fiduciary duties to his clients. To facilitate the implementation of a rescue operation, it was necessary for a PS to take over the full control and management of a company. Only professional practitioners with relevant experience in insolvency work would be appointed as PS. The Administration would discuss with professional bodies, such as the Hong Kong Society of Accountants, to work out the details of the requirement on a PS and to set up a panel of practitioners who could be tasked with the job.

17. The Chairman expressed concern about the stringent requirement on a PS to be personally liable for wages and other statutory entitlements owed to employees who were newly employed or continued to be employed by him after the commencement of the rescue process. In response, DS/FS explained that the requirement would ensure that a PS would discharge his duties prudently and carefully. She said that there had been no objection from professional bodies on the requirement. A PS would first assess the financial position of a company to decide whether or not a rescue operation was worth pursuing. There would also be agreement between the concerned company and PS regarding the latter's duties and liabilities in the rescue operation before his appointment. A PS could request the company to provide indemnity for covering his liabilities arising from the rescue operation.

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For Information
on 5 February 2001

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

Purpose

This paper reports on the results of the Administration's consultation exercise on the Bills Committee's proposal of providing flexibility to the requirement that before undergoing corporate rescue, a company should first settle all outstanding arrears in wages and other statutory entitlements owed to its employees. It also informs Members of the Administration's proposed way forward.

Recommendation

2. We propose to maintain the original proposal of requiring a company to settle all outstanding arrears that it owed to its employees before starting a statutory corporate rescue operation as set out in the Companies (Amendment) Bill 2000. We also propose that certain provisions in the legislative proposal be amended to take into account the submissions made by the various professional bodies and trade organisations in response to the invitation by the Bills Committee set up to scrutinise the Companies (Amendment) Bill 2000.

Background

3. The Law Reform Commission (LRC) recommended in 1996 the introduction of a statutory corporate rescue procedure in Hong Kong whereby a moratorium on legal action would be provided to a company in financial difficulty. The moratorium would enable the company to appoint an independent third party, the ***provisional supervisor***, to try to work out a ***voluntary arrangement*** with the company's creditors. Such procedure would assist businesses in financial difficulties to turn round and continue to operate as going concerns. A copy of the summary of the LRC's recommendations is at Annex A.

Consultation on the Proposed Change in Use of the Protection of Wages on Insolvency Fund

4. In preparing the draft legislation to implement the LRC's recommendations, we noted that the LRC's recommendation to use the Protection of Wages on Insolvency Fund (PWIF) to meet the outstanding claims of those employees who are laid off by a company undergoing supervision would come into conflict with the provisions in the Employment Ordinance (the EO) (Cap. 57). As a result, we conducted a public consultation exercise on the issue in 1998. A copy of the relevant consultation paper is at Annex B.

5. At the end of the consultation exercise, a total of 26 submissions with divergent views were received. Nonetheless, representative bodies of those who would be most directly affected by the proposed rescue procedure, namely, employers and employees, were unanimously against any change to the use of the PWIF, notwithstanding their pledge of "in principle" support for the concept of the proposed procedure. Both the Labour Advisory Board (LAB) and the PWIF Board also expressed strong reservation on making use of the PWIF to bail out private businesses. A copy of the paper reporting on the result of the consultation issued to this Panel in June 1999 is at Annex C.

The Administration's Approach on the Settlement of Employees' Wages Owed by a Company Undergoing Corporate Rescue

6. Having regard to the strong objection to the proposed change to the use of the PWIF, we decided to depart from the LRC's recommendation and adopt the approach of requiring the company wishing to undergo corporate rescue to clear, if any, all arrears in wages, severance pay and other statutory entitlements due and owing by it to its employees before the corporate rescue procedure could be initiated.

7. In essence, we proposed that the appointment of a provisional supervisor of the company should not come into effect unless and until, among others, an affidavit has been filed with the Official Receiver and the court confirming that either the company has no debts and liabilities owing by virtue of the EO to its employees or former employees; or that the company has a ***trust account***, the exclusive purpose of which is to provide funds to pay all debts and liabilities due and owing by the company to its employees and former employees before the commencement of the corporate rescue process.

8. As regards employees who continued to be employed or were newly employed by the provisional supervisor after the commencement of the corporate rescue process, we proposed that the company as well as the provisional supervisor personally should be liable for such employees' wages and other statutory entitlements that the company might owe to them. Where a contract of employment was not accepted or was terminated by the provisional supervisor after the commencement of the corporate rescue process, any outstanding wages, salaries and other emoluments under the contract would be regarded as the liabilities of the company and would be charged on and paid out of the property of the company by the provisional supervisor.

The Companies (Amendment) Bill 2000

9. Legislative proposals based principally on the LRC's recommendations, together with the above modification (paragraphs 6-8), were introduced into the Legislative Council in January 2000 as part of the Companies (Amendment) Bill 2000 (the Bill). A summary of the relevant provisions is at Annex D.

10. During the Bills Committee stage, Members of the Bills Committee, having regard to time constraints and the complexity of the proposals, recommended that the draft provisions on corporate rescue be excised from the Bill and be deferred for re-submission to the Legislative Council at a later stage.

The Bills Committee's Concern

11. Members of the Bills Committee were generally supportive of the proposed statutory corporate rescue procedure. However, some Members expressed doubts on the requirement placed upon a financially troubled company to set aside sufficient funds to settle all arrears of wages, severance pay and other statutory entitlements of its employees as if it were a going concern. They were concerned that the Bill did not provide flexibility in this regard and pointed out that even if the employees concerned were willing to assist the company to turn round by trading in their claims for, say, shares of the company, they would not be permitted to do so under the draft provisions.

12. The Bills Committee suggested that the Administration should consult the LAB on its proposal to provide some flexibility to the requirement to settle all arrears due and owing by the company to its employees.

Flexibility Proposal on the Requirement to Settle all Arrears

13. The intention of setting aside sufficient funds to settle arrears of wages etc. was to protect the statutory rights conferred upon employees under the relevant provisions of the EO. In suggesting that more 'flexibility' should be built into the system, Members of the Bills Committee did not elaborate on how this should be done.

14. Based on the Bills Committee’s comments, we developed a proposal to provide for such flexibility and sought the LAB's and PWIF Board's views. The main features of our proposal are set out below.

15. A company that initiates the corporate rescue process would have two types of employees –

(a) former employees whose employment is terminated before the commencement of the corporate rescue process; and

(b) continuing employees who would be retained by the company when the corporate rescue procedure starts.

Wages in arrears and other outstanding entitlements under the EO may apply to both types of employees. However, in view of their different disposition, they should be accorded different treatments.

Former Employees

16. Under the proposed corporate rescue process, a moratorium on legal action against the company will be put in place once the process is initiated. The moratorium would directly affect the claims of former employees to whom the company owes wages, etc. against the company for arrears of wages and other outstanding entitlements under the EO and their employment contracts. Moreover, when the moratorium is in effect, these employees would not enjoy the protection under the Protection of Wages on Insolvency Ordinance (Cap 380) (PWIO) since ex-gratia payments under the PWIF may only be made when a winding up petition has been presented against the company. Since these employees would no longer have any ties with the company undergoing corporate rescue, we consider that the employer should be required by law to settle, or to set aside an amount to meet, any wages in arrears and other outstanding entitlements due to his former employees before he could proceed with the corporate rescue process.

Continuing Employees

17. Continuing employees are expected to have continuing ties with the company. Hence, they would have a greater interest in the survival of the company. This group of employees may be entitled to –

(a) wages and other entitlements (excluding termination benefits which by definition would not be due and payable to continuing employees) that have been outstanding immediately prior to the commencement of the corporate rescue process; and/or

(b) wages and other entitlements accrued owing since the commencement of the process.

18. In respect of paragraph 17(b) above, the provisions in the corporate rescue legislation will provide that if the provisional supervisor or the company fails to pay the employees their wages accrued owing after the commencement of the corporate rescue process, the employees would be able to present a winding-up petition against the company and make the relevant claims under the PWIO. The moratorium imposed during the corporate rescue process does not apply to such outstanding wages.

Forms of Flexibility Proposed

19. Our proposal would only cover the amounts outstanding in paragraph 17(a) above. Two forms of flexibility have been put forward, namely, a deferral of payment, and payment in lieu of cash (e.g. shares under a trade-in agreement). The specific form would be a matter for the company to negotiate with its employees on an individual basis.

20. Under the deferral of payment arrangement, we proposed that the employer should be allowed to enter into agreement with his continuing employees to defer payment of their arrears in wages and other outstanding entitlements. If the company eventually manages to turn around, the employees would be able to receive the entire amount of wages and entitlements outstanding accumulated before the corporate rescue operation and the employees will be able to enjoy continued employment with a rescued company. Under the payment in lieu of cash arrangement, an employer can enter into agreement with its continuing employees to trade in arrears in wages through payment in considerations other than cash, e.g. by shares.

21. While the employees would be able to enjoy the potential gains from the two proposed flexibility agreements, there is also possible down side risk. A trade-in agreement would effectively discharge the employer's liability for payment of arrears in wages and other entitlements. If the corporate rescue exercise fails and the company goes into liquidation, the employees would not be eligible to make claim to the PWIF in respect of the amounts already traded in. As for the deferred payment arrangement, if the rescue operation eventually fails and the company has to be wound up, there is a real risk that an employee may not be able to recover the full amount of owed wages from the PWIF.[1]

22. To provide the employees with incentive to accept the two proposed forms of flexibility and thus facilitating the initiation of a rescue operation, we have also proposed certain amendments to the provisions of the PWIF Ordinance to afford the employees greater protection than under the existing provisions, e.g. to amend the PWIF Ordinance to make it possible for employees to claim PWIF in respect of wages and other entitlements outstanding before the start of the corporate rescue exercise and more than four months from the last day of service or to amend the PWIF Ordinance to allow employees to make a claim in respect of the amounts traded in, if such flexibility agreements are entered into by them.[2] In this connection, the Education and Manpower Bureau has expressed concern that the proposed amendments especially the idea of allowing employees to make a claim to the PWIF in respect of the amounts traded in would be tantamount to employees using the protection under the PWIF to secure possible benefits from beleaguered employers. The PWIF was not set up for such a purpose and cannot be used in this manner without a change in its mandate. The proposed amendments would also have financial implications for the PWIF.

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[1] Under the PWIO, employees who are owed wages by their insolvent employers may apply to the PWIF for ex-gratia payment to recover arrears of wages not exceeding $36,000 for arrears of wages accrued during a period of four months preceding the applicant's last day of service. Where an employee has agreed to defer payment of wages in order to help the employer to initiate a company rescue operation which, after a period in excess of four months, eventually failed, he will end up in a position whereby he would not able to recover through the PWIF arrears in wages accrued prior to the commencement of the rescue operation.

[2] Under the proposal, for deferred payment agreements, if the corporate rescue exercise fails and the company goes into liquidation, the employees would still be entitled to make a claim to the PWIF in respect of wages and other entitlements outstanding before the start of the exercise and more than four months from the last day of service, subject to the existing ceiling of $36,000. For trade in agreements, continuing employees would be allowed to make a claim to the PWIF for the traded in amount in the event the company eventually goes into liquidation, but again subject to the existing ceiling of $36,000.

Consultation with the PWIF Board and the LAB

23. The PWIF Board and the LAB were consulted on the above two forms of flexibility together with the related legislative amendment proposals on 29 November 2000 and 15 December 2000 respectively. While they supported in principle the introduction of a statutory corporate rescue procedure in Hong Kong, both of them have objected to the flexibility proposal as set out in paragraphs 19 to 22 above. The major reasons of their objections are –

(a) The flexibility proposal would reduce the level of protection accorded to employees under the existing labour legislation which stipulates that, e.g., wage payment should not be made later than seven days upon the expiry of the wage period nor in any form other than in cash.

(b) The PWIF has been set up to provide prompt relief in the form of ex-gratia payment to employees of insolvent employers and not to bail out financially troubled companies. The proposal would alter fundamentally the nature and policy intent of the PWIF. The mandate of the PWIF should not be changed to accommodate the proposal.

(c) The proposal would have financial implications on the PWIF. Given the continued depletion of PWIF due to the upsurge of insolvency cases in recent years, the PWIF should not take on liabilities which would further increase its financial burden.

(d) The outstanding wages and other entitlements owed to the employees usually constitute only a small proportion of the total amount of debts of the companies concerned. Hence, in most cases, a company undergoing corporate rescue should be able to set aside sufficient funds for clearing its debts to the employees.

(e) Because of possible impairment of their interests, most employees would not accept deferred payment or payment other than cash. Consequently, even if the proposed flexibility arrangements were incorporated into the statutory procedure, they might not be able to achieve the purpose of relieving the financial burden of the company.

Both the PWIF Board and the LAB have asked the Administration to adhere to the original proposal on settlement of arrears in wages as set out in the Companies (Amendment) Bill 2000, i.e. a company has to clear all outstanding debts and liabilities that it owed to its employees before the commencement of the corporate rescue procedure.

24. We recognise that any statutory corporate rescue procedure must be workable, bearing in mind the needs of the company in difficulty, interests of creditors, and rights of employees. Having regard to the views of the PWIF Board and the LAB, we intend to adopt a pragmatic approach, balancing the interest of all the relevant parties, and maintain the position as originally provided in the Companies (Amendment) Bill 2000, i.e. the framework as set out in paragraphs 6 to 8 above.

Other Amendments to the Provisions of the Legislative Proposal

25. At the invitation of the Bills Committee in 2000, a number of professional bodies and trade organisations have made submissions on the various provisions in the legislative proposal and we have carefully reviewed the submissions received. Taking into account the views and suggestions put forward, we are proposing to modify some of the provisions in the original legislative proposal. The major items are set out in paragraphs 26 to 30 below.

Secured Creditor's Rights

26. Under the LRC's proposal, a company has to notify its major secured creditor of the proposed rescue. The latter has the right to object the initiation of the procedure and upon the receipt of such objection by the provisional supervisor, the provisional supervision will end. LRC has not proposed to accord the same treatment to other minor secured creditors, i.e. they are not given the option to elect to participate in the proposed rescue or abstain from it by relying on their securities. They are, nonetheless, bound by the terms of the voluntary arrangement that may eventually be drawn up at the end of the rescue operation, including any reduction of their money right or enforcement right under their security. The above LRC proposal has been incorporated into the legislative proposal.

27. A number of professional bodies, trade organisations as well as academics have pointed out that the LRC's proposal represents a major departure from the long established and respected secured lending practice, i.e. secured creditors, be they large or small, cannot be forced to

accept any "hair-cut" of debts without their consent. Having considered such comments, and taking into account the fact that the approach proposed in the Companies (Amendment) Bill 2000 might change the existing secured lending practice and cause havoc to the lending institutions and the business community, we now propose that the procedure be modified so that the existing rights of the secured creditors would remain unaffected. Under the revised proposal, all secured creditors, major or minor ones, would be accorded the same protection, i.e. their rights as secured creditors cannot and will not be affected by the proposed voluntary arrangement except with their concurrence.

Voidable Transactions

28. Under the present proposed procedure, a provisional supervisor, unlike a liquidator in a winding-up, does not have the power to investigate into voidable transactions made prior to the start of the rescue procedure. In response to the submissions made by the professional bodies, we now propose to strengthen the relevant provisions in the legislative proposal by giving the provisional supervisor the necessary power to carry out investigation into voidable transactions. To assist the creditors to come to an informed decision on whether to proceed with a voluntary arrangement or a creditor's voluntary winding-up, the provisional supervisor will also be required to report his investigation result on such transactions to the creditors meeting.

Trust Account For Debts and Liabilities Owed to Employees

29. Our policy intention is that the company should settle all outstanding debts and liabilities owed to its employees by virtue of the EO before it can start the rescue operation. The trust account requirement provision has been put in to cater for situations whereby it is not possible for the company to clear all the debts and liabilities before the start of the operation, e.g. the wage payment date is not yet due. The provisional supervisor is required to make the necessary payments to the employees by drawing on the fund in the trust account. Given the fact that the provisional supervisor would have to carry out a large number of tasks once he takes office, we have deliberately refrained from prescribing a timeframe in the Companies (Amendment) Bill 2000 within which he has to made the payment so as to afford the provisional supervisor some latitude in this regard. However, some of the respondents have formed the misconception in their submissions that the fund in the trust account is simply frozen and that payment will only be made if and after the proposal is accepted. For the avoidance of doubt,

we now propose to set out clearly in the draft legislation that the provisional supervisor is required to make payments to the employees prior to the convening of the creditors' meeting on the voluntary arrangement proposal without regard to the outcome of the proposal.

Meeting of Members of the Company

30. Under the LRC's proposal, both solvent and insolvent companies in financial difficulties can also make use of the provisional supervision. The proposal has been made on the premise that the sooner a company faces up to its financial problems, the greater chance of success for the rescue operation and hence the company turning round. Moreover, the voluntary arrangement eventually agreed will be binding not only on the relevant creditors, the company but also members of the company. Given their interests are also at stake, it is only fair that members should also be given a say in the future of the company. It is therefore proposed that, apart from being discussed at a creditors' meeting, a voluntary arrangement proposal should also be discussed at a members' meeting. The requirement is to be applied across the board, i.e. to both solvent and insolvent companies. In the event the decision of the members' meeting is different from that of the creditors' meeting, the decision of the creditors would prevail but a member may apply to court for determination.

The Way Forward

31. Having regard to the objections by the PWIF Board and the LAB, we have decided not to pursue the flexibility proposal put forward by the Bills Committee. Instead, we shall maintain the original proposal of requiring the settlement by a company of all debts and liabilities that it owed to its employees before the start of the rescue procedure. Separately, we shall modify the relevant provisions in the legislative proposal to take into account the views and suggestions made in the submissions to the Bills Committee.

32. We intend to re-introduce the relevant legislative proposal into the Legislative Council for consideration within the current session.

Financial Services Bureau
1 February 2001

Annex A

SUMMARY OF
REPORT ON CORPORATE RESCUE
AND INSOLVENT TRADING
ISSUED BY
THE LAW REFORM COMMISSION OF HONG KONG

Provisional Supervision: (Chapters 1 and 3 of the Report)

1. At present, Hong Kong companies that get into financial difficulties may try to come to an arrangement with their creditors by means of a non-statutory arrangement or by means of the arrangement and reconstruction provisions under section 166 of the Companies Ordinance. The major deficiency of these arrangements is the lack of a moratorium (stay of proceedings) that can bind creditors while an arrangement plan is being formulated.

2. Provisional supervision leading to a voluntary arrangement would be a vehicle which would facilitate a company in avoiding winding up, to survive in whole or in part as a going concern, or satisfy its debts in whole or in part through a more advantageous realisation of the company's assets or a better return for creditors and members than would result from a winding up. These general purposes could be achieved in a variety of ways through voluntary arrangements; such as/by:

(a) an extension of time for payment of debts,
(b) a composition in satisfaction of its debts,
(c) the compromise of any claims against the company,
(d) the variation or the reordering of the rating for payment of its debts or any class of its debts,
(e) the conversion of its debts in whole or in part into shares or other securities to be issued by the company, or
(f) any other scheme or arrangement in relation to the affairs of the company.

3. Provisional supervision would:

(a) provide a solid basis on which to calculate the costs and time involved in putting a proposal to creditors.
(b) provide a flexible framework to allow a provisional supervisor to work under court protection from the outset.
(c) limit the costs of court appearances as the provisional supervisor would only have to go to court after 30 days and after that only when an extension of provisional supervision was sought or the company was deemed to be would up as a creditors voluntary winding up.
(d) set out the role of the provisional supervisor, give the provisional supervisor the power of management, prevent creditors from threatening proceedings as a form of leverage. permit super priority borrowing. allows creditors to vote on the proposal and provide a transition into a company voluntary arrangement or winding-up.
(e) provide certainty. Creditors could be sure that after not more than six months they would have their say on a proposal.

Benefits of provisional supervision

4. If a company can achieve a voluntary arrangement under supervision, there are good prospects that it can return to profitability. This is attractive to the shareholders, who generally have the lowest priority when it comes to the distribution of the assets of a company that has gone into liquidation from a winding up.

5. The preservation of jobs is of the utmost importance. For additional comment on employees see paragraph 19 below.

6. Unsecured creditors are often considered to have a raw deal in a liquidation. In the fours between 1991/92 and 1994/95 it took an average time of 5.12 years to pay an average rate of 27.78% first and final dividend to ordinary creditors.

7. It is not unusual for there to be multiple secured creditors with varying securities and priorities over the assets of a company. Because of the nature of floating charges in particular, which permit a company to deal with the assets covered by the floating charge in the ordinary course of business, the value of a company's assets can diminish, leaving some or all of the secured creditors under-secured.

Companies To Whom Provisional Supervision Would Apply (Chapter 2 of the Report)

8. The procedure should apply to companies formed and/or registered under Parts I and XI of the Companies Ordinance but excluding certain regulated industries. Provisional supervision would apply to both listed and unlisted companies. Companies registered under Part I of the Companies Ordinance account for most companies in Hong Kong, including both private and public companies. Part XI of the Companies Ordinance relates to companies incorporated outside Hong Kong, which are referred to in Part XI as "oversea companies".

9. The inclusion of oversea companies is important as Hong Kong is a major international trading, manufacturing and financial centre and there are a considerable number of international companies operating in Hong Kong in one form or another. Oversea companies operating in Hong Kong have the choice of forming a Hong Kong subsidiary under Part I of the Companies Ordinance or registering as an oversea company under Part XI.

Companies to whom the procedure would not apply

10. The procedure should not apply to industries that were already regulated by statute and which have provision for the relevant authority to assume control of the business or oblige a business to act in a certain manner. The regulatory powers of each industry differ substantially, according to their needs. Provisional supervision should not therefore be imposed on regulated industries but the relevant regulatory bodies should consider whether to apply a remedial procedure through their own legislation. The regulated industries recognised were banking, insurance and securities and futures.

Purposes Of Provisional Supervision (Chapter 3 of the Report)

11. A company should be able to go into provisional supervision whether it was able to pay its debts or not. A solvent company which recognised that it was trading into

difficulties should be able to avail itself of supervision. It would stand a better chance of a successful reorganisation than a company that continued trading until it was insolvent. It would be good management practice to act earlier rather than later in initiating provisional supervision.

Those Who May Initiate The Procedure (Chapter 4 of the Report)

12. In addition to the company or its directors, liquidators and receivers should be able to initiate, or give their consent to initiate, the procedure in appropriate circumstances. The intention is that whoever has power to initiate should do so from a position of knowledge of the company's financial position and prospects. It is for this reason that creditors should not be able to initiate the procedure.

The Moratorium (or Stay of Proceedings): (Chapter 5 of the Report)

13. The moratorium should commence upon the filing of a resolution of the company or the board of directors and the consent of the provisional supervisor to act. The initial moratorium period should be for 30 days from the commencement of provisional supervision after which, if the provisional supervisor has not formulated a proposal for creditors, he may apply to the court for an extension or extensions.

14. The provisional supervisor need only apply to the court for an extension if he is unable to complete an arrangement plan within the initial 30 day period. After that, the court should grant an extension or extensions of 30 days or more. If the provisional supervisor reports that he is likely to be able to complete the plan but not within a further 30 days, the court should have the discretion to extend the moratorium for any period up to a maximum of six months from the commencement of the moratorium.

15. Eligible financial contracts, which occur in certain closed markets such as the central clearing and settlement system of the Stock Exchange of Hong Kong Limited, should be exempted from the moratorium.

16. At the end of six months, the court would cease to have any role in monitoring the provisional supervisor as regards extensions of the moratorium. If the creditors resolved to extend the moratorium beyond six months they could impose such conditions as they wished on the provisional supervisor relating to reviewing the extension.

17. If the court was satisfied that the moratorium was causing significant financial hardship to a creditor, the court could exempt that creditor from the moratorium and any voluntary arrangement and the moratorium would cease to apply to that creditor and the creditor would not be subject to any subsequent voluntary arrangement.

18. The provisional supervisor should have the power to exclude any class or classes of creditors from the moratorium, in which case the moratorium would cease to apply to them.

19. At present, employees who are laid off by a company that does not go into liquidation are not able to make a claim for compensation from the Protection of Wages on Insolvency Fund, as the Fund is only triggered by the winding-up of the company or by advice from Legal Aid that the company is unable to pay its debts. On a provisional supervision, employees could therefore be cut out and left without the prospect of any

interim payment from the Fund. It would be desirable for employees who have been laid off as a consequence of provisional supervision to be accommodated under the provisions of the Protection of Wages on Insolvency Ordinance. Until that happens, a provision similar to section 79 of the Companies Ordinance should be made to the effect that, where a provisional supervisor is appointed to a company the debts of employees which in every winding-up are preferential payments under section 265 of the Companies Ordinance, be paid in priority to all other debts according to their respective priorities under section 265, out of the assets coming into the hands of the provisional supervisor in priority to any other claim.

20. The moratorium should cease upon a resolution being passed either to terminate the provisional supervision or that the company should be wound up or on the approval or rejection by creditors of a voluntary arrangement plan.

Initiating The Procedure (Chapter 6 of the Report)

21. A proposal for a voluntary arrangement should not have any effect until a resolution of the company or the board of directors proposing a voluntary arrangement, or, if appropriate, of the proposal of a liquidator in a compulsory winding up, a consent to act of the provisional supervisor, and an affidavit of the directors setting out the reasons for initiating provisional supervision, have been filed at both the Supreme Court Registry and the Companies Registry. The effect of the filing of the documents would be to put the company into provisional supervision, the commencement date being the date of last filing of the resolution and the consent to act.

22. The affidavit of the board of directors should set out the reasons for initiating provisional supervision and a declaration to the effect that in the opinion of the directors the interests of the company and creditors would be best served by the process of provisional supervision. The affidavit would be useful to the court in considering later applications for extensions of the moratorium and would also give some reassurance to the creditors.

Who May Be The Provisional Supervisor (Chapter 7 of the Report)

23. In most cases provisional supervisors should only be selected from a panel of practitioners which would be operated by the Official Receiver. In addition to appointment of provisional supervisors through a panel the court may 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. Once a provisional supervisor is appointed he would not only assume control of the company but would also be involved in the day to day business of the company in addition to formulating an arrangement plan.

Role Of The Provisional Supervisor (Chapter 8 of the Report)

24. If the provisional supervisor was to leave the day to day running of a company in the hands of the management and to limit himself with examining the records of the company and working behind the scenes to formulate a plan there would be a danger on two fronts. First, the provisional supervisor might fail to gain the confidence of the creditors if it was perceived that he was not in full control. Second, if a provisional supervisor did not have control over the management of a company, it would increase the

chances of a company's assets being dissipated by unscrupulous directors. It would not therefore be appropriate to allow management retain full control of a company and accordingly the provisional supervisor should have executive functions.

25. The functions of the provisional supervisor would be:

(a) to assess the financial position of the company, after which he should;
(b) decide whether or not any of the purposes of a voluntary arrangement were capable of being achieved;
(c) if he decided that any of the purposes of a voluntary arrangement were capable of being achieved, he should then formulate a plan to achieve the intended purpose;
(d) once he formulated a plan, he should submit it to a meeting or meetings of creditors for acceptance or otherwise by the creditors within the initial moratorium period in so far as that was possible;
(e) if the provisional supervisor, having assessed the financial position of the company, decided that none of the purposes of a voluntary arrangement were capable of being achieved he should call a meeting of creditors;
(f) if the provisional supervisor, having commenced the formulation of an arrangement plan, found that he was unable to complete the formulation of the plan, he should call a meeting of creditors to provide them with a final opportunity to come up with a plan to save the company or to resolve that the company should be would up;
(g) during the provisional supervision period he should do all things necessary to protect the assets of the company;
(h) during the provisional supervision he should manage the affairs, business and property of the company with the primary purpose of preserving the assets of the company for the creditors as a whole;
(i) he should act in the best interests of the company;
(j) he should make a report to the Official Receiver if a director was or had been a director of a company which had at any time become insolvent whether while he was a director or subsequently and that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or companies, made him unfit to be concerned in the management of a company.

Duties, Rights And Liabilities Of The Provisional Supervisor (Chapter 9 of the Report)

26. Subject to his overriding duty to supervise the affairs of the company and to carry out his functions, the provisional supervisor should be under a duty to do all things necessary to protect the assets of a company for the benefit of the creditors. The provisional supervisor should have the right to approach the court for directions. The provisional supervisor should not be liable for any of the debts of the company which arose before his appointment.

27. The provisional supervisor should be entitled to such remuneration as would be agreed between him and whoever initiated the procedure and caused him to act. The level of the remuneration should be specified in a prescribed form in the consent to act.

Ascertaining The Company's Affairs (Chapter 10 of the Report)

28. When a provisional supervisor is appointed he will need to assimilate a great deal of information in a short time, including establishing the extent and whereabouts of the assets of the company and taking control of them. In order to achieve this, the provisional supervisor would need powers to require information to be put at his disposal without undue delay and for assistance to be afforded to him by those who had knowledge of the company's affairs. The provisional supervisor should therefore have the power to obtain a statement of affairs of the company from specified persons, including directors and employees, within a relatively short time after his appointment.

Removal And Resignation Of The Provisional Supervisor (Chapter 11 of the Report)

29. The provisional supervisor should only be capable of removal for cause shown.

30. The provisional supervisor should be able to resign without cause shown where a majority of the creditors and the provisional supervisor himself agree to such a course and another provisional supervisor agrees to be appointed to the position. Resignation should not otherwise be possible other than where a provisional supervisor died or through mental incapacity.

Super Priority (Chapter 12 of the Report)

31. Provision should be made for a company to borrow during provisional supervision and such borrowing should receive priority over all existing debts, with the exception of fixed charges. This is because, in all likelihood, a company in provisional supervision would need to raise capital to fund its operations during the provisional supervision period. Existing lenders should be given first refusal on any super priority lending the company may require. If existing lenders declined to provide the lending, the provisional supervisor should then be able to seek super priority lending from other sources. Super priority lending would apply only to funds provided for working capital for the company and these funds should not be used to discharge, in whole or in part, any liability of the company to the provider of the funds existing at the commencement of the provisional supervision period.

Secured Creditors (Chapter 13 of the Report)

32. Any substantial charge, whether it was fixed or floating, or a combination of both, should carry the right to elect whether to participate in provisional supervision The effect of an election not to participate and thus effectively end provisional supervision would return a company to the position it was in just a few days previously. Creditors, secured and unsecured, could take the usual forms of action. Other secured creditors, that is, holders of charges whose level of exposure or lending would not warrant a charge over the whole or substantially the whole of a company's assets, would be bound by a moratorium in the same way as unsecured creditors, and would not have the option to elect whether to participate in provisional supervision.

Procedures For Meetings Of Creditors (Chapter 16 of the Report)

33. Any meeting of creditors to consider any matter relating to provisional supervision, creditors should form one class. The quorum for any meeting of creditors should be one creditor present and entitled to vote. For any resolution to pass at a meeting of creditors approving a proposal, there should be a majority in number and in excess of two thirds in value of the creditors present in person or by proxy and voting on the resolution.

34. Where a voluntary arrangement plan is approved by creditors, the provisional supervision should cease and the terms of the voluntary arrangement should take effect. The voluntary arrangement would be binding on every creditor who was entitled to vote at a meeting at which the arrangement plan was approved, and on the company and its members.

Consequences Of The Approval Of A Voluntary Arrangement (Chapter 17 of the Report)

35. Even after a company enters into a voluntary arrangement it would need protection. It should be a condition of every voluntary arrangement that, while it was in effect, the parties to the voluntary arrangement should be prohibited from taking actions that would be to the detriment of the other parties to the arrangement; therefore:

(a) no creditor bound by the arrangement may commence or continue any winding up proceedings against the company;
(b) no resolution may be passed or made by the members or the directors of the company for the winding up of the company:
(c) no receiver of the company may be appointed by a creditor bound by the arrangement or, if already appointed, no receiver may exercise any powers incidental to the office;
(d) no creditor bound by the arrangement may take any step to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession;
(e) no creditor bound by the arrangement may commence any proceedings, execution, distress or other legal process against the company.

The Supervisor Of A Voluntary Arrangement (Chapter 18 of the Report)

36. The supervisor of a voluntary arrangement should only be capable of appointment from the Official Receiver's panel. In most cases he would probably be the provisional supervisor. A supervisor of a voluntary arrangement should perform such duties and functions and have such powers as may be specified in the arrangement and ascertain on behalf of the creditors that the arrangement was being adhered to and implemented by the company in accordance with its terms. The supervisor should supervise the arrangement having regard to the interests of the creditors of the company, the company itself and the shareholders of the company.

Insolvent Trading (Chapter 19 of the Report)

37. Directors of a company should be subject to liability for insolvent trading once a company traded while insolvent or if the company continued to trade when there was no reasonable prospect of preventing the company becoming insolvent. A lesser duty should be imposed on senior management of a company. Directors and senior management, collectively known as "responsible persons" would be liable to pay compensation to the company if they were found by the court to have failed in their respective duties. Insolvent trading provision should encourage responsible persons to face the fact that a company was slipping into insolvency and cause them to take action rather than to trade on regardless of the consequences.

38. Provisional supervision would be a civil remedy only; there should be no criminal element. There is no reason for making an application for insolvent trading unless a company had gone into insolvent liquidation as, in practical terms, if a company remained in business there would be no one, such as a liquidator, who would be in a position to form a view that insolvent trading had taken place. The power to make an application in respect of insolvent trading should vest in a liquidator only.

39. Insolvent trading should apply to all directors whether they were validly appointed directors, persons who held themselves out to be directors though they had not been validly appointed, and shadow directors. Liability for insolvent trading should not be collective and liquidators should take account of a director's actions prior to liquidation. The ability and expertise of a director should be taken into account. A responsible director should, therefore, be able to protect himself by showing that he had warned the board about insolvent trading and that he had opposed the course of action the company had taken which resulted in insolvent liquidation.

40. Senior management should be liable to pay compensation for insolvent trading if they failed to warn the board of directors that the company was trading into insolvency. Senior management's duty would be lower than that of directors as the power to wind-up a company voluntarily or to initiate provisional supervision would only lie in the board of directors. Liability should extend to those in management who would know, who ought to have known or who had reasonable grounds for suspecting that a company was insolvent or would become insolvent and failed to warn the board of directors of the situation.

41. As most companies operate on a cash flow basis and can readily establish whether a company is able to discharge its liabilities as they fall due the cash flow test is the basis on which liability should be founded.

42. In order for a liability for insolvent trading to arise certain factual conditions would have to be established. These are (i) that a director is or has been a director of an insolvent company at the time when the debt or debts were incurred and that (ii) the company was insolvent at that time or there was no reasonable prospect of avoiding becoming insolvent. A liquidator must then consider whether a director, at that time, (i) knew the company was insolvent, or (ii) ought to have known that the company was insolvent or would so become, or (iii) that there were reasonable grounds for suspecting that the company was insolvent or would become insolvent and failed to take action to prevent the company from incurring the debt. The third limb of the factual conditions refers to reasonable grounds for suspecting insolvency. A director would be considered to have suspicions if, (i) he was aware at the time that there were grounds for so suspecting, or (ii) if a director in a like position in a company, in the company's circumstances, would be so aware.

43. In determining whether warning was given in good time the same factual conditions as set out above in respect of directors would be applied to senior management.

Presumptions

44. The effect of a presumption of continuing insolvency is that, if it is proved that a company was insolvent at a particular time during the 12 months ending on the date of commencement of its winding up, it would be presumed that the company was insolvent throughout the period beginning at that time and ending with the winding up of the company. this would prevent responsible persons defending an application for trading while insolvent by claiming that the company was actually solvent at a particular date, or for a certain period, during the period between the date when insolvency is shown and the date of winding up. Where circumstances of insolvency are established as having existed at a particular time within 12 months of winding up, it would shift the burden of proving the contrary on to the responsible persons.

45. If it is proved that a company had, at a particular time during the 12 months ending on the date of commencement of the winding-up, contravened section 121 of the Companies Ordinance by failing to keep proper accounting records there should be a presumption that the company was insolvent throughout the relevant period.

Defences

46. A director should have a defence to an application against him for insolvent trading if he could satisfy the court that, at the time when he knew or ought to have known that the company was insolvent or would become so or that there were reasonable grounds for suspecting that the company was insolvent or would become insolvent, he took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken. For the purposes of the defence, the facts which a director ought to have known or ascertain, or the conclusions which he ought to reach and the steps he ought to take, are those which would be known and ascertained, or reached or taken, by a reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general knowledge, skill and experience that director has.

47. A senior manager would have a defence to an application against him for insolvent trading if he could demonstrate that he had given the board of directors notice in the prescribed form that a company was trading insolvently or was about to trade insolvently.

Responsible persons may be liable to compensate the company

48. If the court finds a responsible person liable for insolvent trading it should be able to order the responsible person to pay compensation to the company for the benefit of the general body of creditors which would equal the general deficiency when it was wound up. It should be left to the discretion of the court to decide the amount of compensation that should be awarded against a responsible person as the actions of each responsible person would have to be judged separately. Compensation recovered should be paid to the company for the benefit of the general body of creditors in accordance with the existing priorities, unless the court orders otherwise.

49. If the court makes a declaration that a responsible person, whether he is a director or senior manager, is liable to pay compensation for insolvent trading, the court should have the discretion to make an order disqualifying that person from being a director of

any company under Part IVA of the Companies Ordinance. If a person acted as a director of a company which went into insolvent liquidation at a time when he was disqualified as a director under Part IVA of the Companies Ordinance, he may be held liable for the debts of the company.

Annex B

Consultation Paper on
Corporate Rescue and the Protection of Wages on Insolvency Fund
(Treatment of Employees in "Provisional Supervision")

Problem

There are incompatibilities between some recommendations in the scheme proposed by the Law Reform Commission's ("LRC") Report on "Corporate Rescue and Insolvent Trading" and the existing labour legislation. It is necessary to resolve these incompatibilities if the Government were to take forward the relevant proposals.

Comments sought

2. Comments are sought on how employees' outstanding entitlements should be settled if the company which owes these debts initiated a corporate rescue procedure.

Background

Why Hong Kong needs corporate rescue (also known as "provisional supervision")

3. At present, companies that get into financial difficulties may try to come to an arrangement with their creditors by means of a non-statutory arrangement or by means of the arrangement and reconstruction provisions under section 166 of the Companies Ordinance (the "CO"). However, there is no moratorium (that is, stay of proceedings) thus nothing in either procedure to prevent a single breakaway creditor withdrawing from the negotiations and presenting a petition to wind up the company, thereby sink any rescue arrangement. In this particular aspect, therefore, there is a clear deficiency in section 166 of the Ordinance.

The Law Reform Commission's proposal on corporate rescue

4. The LRC Sub-committee on Insolvency examined the issue in 1995 and circulated a consultation paper for public comments. In that paper, the Sub-committee recommended a statutory corporate rescue, also known as "provisional supervision", to be introduced to facilitate a company in working out a voluntary

arrangement with creditors. The aim is to provide a procedure with guaranteed court protection at the outset to allow a provisional supervisor to work out some arrangements that would assist a viable business to survive, in whole or in part, as a going concern than for it to be simply wound up. During the 3-month public consultation, the Sub-committee received a total of 30 substantive submissions. Apart from one submission which expressed serious reservation about the proposal and questioned the need for "Government-mandated" intervention in corporate failure at all, the Sub-committee found the balance of the opinion to be strongly supportive.

5. Subsequently, the LRC substantially supported the Sub-committee's recommendations and issued the final report on "Corporate Rescue and Insolvent Trading" in October 1996 endorsing the introduction of a statutory corporate rescue in Hong Kong. The LRC considered that it would benefit the company's shareholders, general creditors, the secured creditors as well as employees who would otherwise lose their jobs consequent to the winding up of the company. A summary of the LRC report is at the Annex.[1]

Main features of corporate rescue/provisional supervision

6. The main features of provisional supervision are as follows -

(a) the imposition of a moratorium against the company, initially for 30 days but which can be extended by the court for up to 6 months or even beyond with the consent of the creditors, the effect of which is to prevent individual creditors including employees from exercising their normal right to take proceeding and to preserve the assets of the company while a proposal is prepared for consideration by creditors;

(b) the appointment of a provisional supervisor, an independent qualified third party who would take control of the company as soon as he is appointed and formulate a proposal within a certain time frame to be put to the creditors which are bound by the moratorium;

(c) the procedure would be initiated by either the company's directors or members, or a receiver or a liquidator if the company has gone into receivership/provisional liquidation, but not the creditors; and

(d) the moratorium should cease upon a resolution passed either to terminate the provisional supervision or that the company should be

[1] The full report of the LRC is available on request.

wound up or on approval or rejection by creditors of a voluntary arrangement plan.

Effect of the moratorium on employees - claim on PWIF impaired

7. Most of the recommendations in the LRC report deal with the technical and procedural requirements for the initiation and implementation of a provisional supervision. One particular issue - the settlement of employees' arrears of wages and other entitlements - nevertheless requires further deliberation because the LRC's proposals, if accepted, would be incompatible with existing labour legislation.

8. As the legislation stands, those employees who are laid off by the company under provisional supervision will not be able to make a claim for ex-gratia payment from the Protection of Wages on Insolvency Fund (PWIF), which is only triggered by the presentation of a winding-up petition to the court against the company. On a provisional supervision, employees could therefore be cut out and left without the prospect of any interim relief payment from the PWIF, in the absence of a winding-up petition against the company. In addition, given that a moratorium is in force, those affected employees are disallowed from filing any winding-up petition hence their right to the PWIF is further impaired.

LRC's proposal on treatment of debts owed to employees

9. The LRC recognised this problem and considered that-

(a) it would be desirable for employees who have been laid off as a consequence of provisional supervision to be accommodated under the provisions of the Protection of Wages on Insolvency Ordinance;

(b) until that happens, the debts owed to employees which in every winding up are preferential payments under section 265 of the CO will be paid in priority to all other claims out of the assets coming into the hands of the provisional supervisor; and

(c) for employees who remain with the company and are owed arrears of wages from before the appointment of the provisional supervisor, such arrears should be given the same priority given to the wages of the employees who have been laid off.

<u>Problem - Incompatibilities with existing labour legislation</u>

LRC proposal (a) - widening the ambit of PWIF = subsidising employers and possible contravention of the Employment Ordinance (the "EO")

10. The LRC's proposal in paragraph 9(a) above would involve expanding the ambit of the PWIF, and this would change fundamentally the rationale for which the Fund is set up. To allow employees laid off by provisional supervision to be paid out straight from the Fund would be tantamount to subsidising the employers who are then relieved from their statutory obligation to pay their employees upon termination of contract/service. There might be abuse of the scheme by unscrupulous employers who try to evade such responsibility under the disguise of corporate rescue. There might also be significant financial implications on the PWIF.

11. Furthermore, in reality, payment from the PWIF does not necessarily cover the full amount of the employees' entitlements which are statutorily required to be paid by an employer in accordance with the provisions of the EO. The requirements in the EO are aimed at protecting the employees' rights. This proposal may be in breach of the provisions of the EO.

LRC proposal (b) - preferential payment under the CO significantly fall short of employees' entitlement under PWIF

12. The proposed arrangement in paragraph 9(b) above proposing to treat employees' arrears as priority debts under the CO are not practicable for the simple reason that in monetary terms, it falls short of the level of protection that employees could get from the PWIF by a very significant margin - maximum of $200,000. The current maximum amount of ex-gratia payments made by the PWIF are $36,000 for arrears of wages, $22,500 for wages in lieu of notice and $36,000 plus 50% of excess entitlements for severance payment, up to a maximum of about $211,500. By comparison, the maximum amount an employee could get as priority debts under the preferential limits stipulated in the CO is only $18,000**,** which is the aggregate of $8,000 for arrears of wages, $2,000 for wages in lieu of notice and $8,000 for severance payment. There is therefore no incentive for employees to accept this arrangement.

LRC proposal (c) - employees continue with the company but are owed wages from previous employment = possible contravention of the EO

13. The LRC proposal in paragraph 9(c) above may cause the provisional supervisor to be in breach of section 31 of the EO, which provides that "no person

shall enter into, renew or continue a contract of employment as an employer unless he believes upon reasonable ground that he will be able to pay wages due under the contract of employment as they become due. The employer, without reasonable belief that he can pay wages, shall forthwith take all necessary steps to terminate the contract in accordance with its terms". Hence the provisional supervisor, who is in law the agent of the company, would be in breach of the EO if he continues to employ some employees during the moratorium while at the same time fails to clear all their arrears of wages owed before his appointment.

<u>Protection of employees' rights</u>

14. Can some sort of exemption under the EO be given to companies undergoing corporate rescue? We consider that the possible contravention of the EO as identified from the LRC proposals represent some of the most fundamental protection of employees' rights in Hong Kong. There is no question of exemption for any employer from those provisions unless there are compelling grounds.

15. The LRC proposals are therefore "incompatible" with the provisions of the PWIO and the EO, and might create financial hardship to certain employees. If corporate rescue scheme were to be introduced, the position with regard to employees must be that the level of protection that they can obtain should be no less favourable than what they are entitled to under the existing legislation.

<u>Who to pay the employees?</u>

16. The crux of the matter now is to identify the appropriate party to pay the employees' outstanding debts owed by a company which initiated corporate rescue.

The PWIF? (Option A) (LRC proposal)

17. Although employees laid off as a consequence of a company going into provisional supervision would not be, strictly speaking, employees of a company in liquidation, the reality is that they would have been if corporate rescue had not been available. The PWIF has to pay later if not sooner.

18. However, this option raises a fundamental issue - the purpose of the PWIF. Policy-wise, making unconditional payment to workers laid off by the provisional supervision would be tantamount to granting a loan to bail out the company, in effect turning the Fund into a "Corporate Rescue Fund", since a company in provisional supervision is a going concern. Since its establishment,

the policy intention of the Fund has been to provide ex-gratia payment to workers only in the event their employer is insolvent. The proposed expansion of the scope of the Fund will drastically alter the nature of the Fund and represent a fundamental change to the purpose for which it has been set up.

19. There could be significant impact on the PWIF, although it is difficult to give an assessment of the financial and resource implications involved as no one can predict how many corporations will be in need of rescue and the number of employees affected. We believe that in a period of economic downturn, more companies would resort to corporate rescue hence there would be definitely be a heavier drain on the Fund.

20. A question therefore arises as to where should the Fund turn to for additional funding if necessary. In addressing this issue, it is important to bear in mind the underlying spirit and principle of the PWIF, which is a fund contributed by employers to provide prompt relief in the form of ex-gratia payment to employees in situations where the employers have become insolvent and owed employees wages and other statutory termination benefits. There is thus no question of the use of public funds to "bail out" the PWIF should its finances become inadequate as a result of its ambit expanded to facilitate businesses undergoing corporate rescue.

Financial position of the PWIF

21. The PWIF is funded by a levy on business registration certificate, which is at present $250 per certificate per annum. Since its establishment in 1985, the PWIF has accumulated assets amounting to $852 million to the end of March 1998. Whilst in past years the PWIF used to have an excess of income over expenditure, the situation reversed in 1997/98, when the Fund registered a deficit of $25 million. In 1998/99, the deficit is expected to increase further to $90 million. It should be pointed out that the full impact of the recent downturn of the economy on the PWIF has yet to be felt. Apart from a very substantial increase in the number of applications to the PWIF, it is noteworthy that a single big insolvency case such as Yaohan could involve total payments from the PWIF to the tune of over $67 million. It is therefore important that the PWIF should maintain a healthy reserve to enable it to cope with all contingencies. Thus, it should be made clear from the outset that Option A would entail an upward adjustment to the current PWIF levy of $250. While it is difficult to assess the impact on the Fund, it would be prudent not to leave the issue of increasing the levy to the stage when the Fund runs into financial difficulties as a result of payments made in cases of corporate rescue.

The Employer? (Option B)

22. Legally speaking, it is the statutory duty of the employer to pay an employee's wages and entitlement in full as and when his service to a company is being terminated. If an employer cannot even pay his employees, it cast doubt on whether a corporate rescue scheme is likely to succeed. This perhaps indicates that the company should have moved into provisional supervision at a much earlier date.

23. Realistically, it would be impractical in demanding a financially-troubled company to pay a lump sum upfront to clear its indebtedness to employees before it goes into provisional supervision. It would put a heavy financial burden on the company and might instead exacerbate the financial hardship of the company and speed up its collapse. Or, it would make it so difficult that very few, if any, companies can actually benefit from the new scheme.

24. In some cases, a troubled company which may be suitable for rescue will in normal order of things has a severe cash flow problem but may have orders on its books and may in some cases have not readily realisable or collectable assets. Such a company will be unable to find the cash or obtain finance prior to the rescue to settle its liabilities to employees. It is also impractical and unrealistic to expect insolvency practitioners to take on the role of a supervisor to such companies where their fees are in jeopardy of being paid. In the circumstances, a full liquidation would appear the only solution and this would create further unemployment which is contrary to the general intention of implementing corporate rescue.

Exempting all employees from the moratorium? (Option C)

25. This will allow employees to exercise their rights to petition for the winding-up of the company anytime even when the latter is in provisional supervision. This will preserve employees' rights to the PWIF and upon the presentation of a winding up petition of the company to the court, the PWIF Board may make payment to employees.

26. The obvious downside of this option is that it will put the provisional supervisor under continuous threat and defeat the purpose of the moratorium which should enable the provisional supervisor to take on his task in relative peace and be guaranteed court protection from the outset. It will be up to the court to decide whether the petition should be granted or stayed. Likewise, there

would be financial implications on the PWIF whose scope in essence has been broadened and this would entail an upward adjustment of the $250 PWIF levy.

The practice in other jurisdictions

27. Corporate rescue, or similar schemes, are practised in various jurisdictions, such as the US, UK, Canada, Germany, Australia, Japan and Singapore. In most cases, we do not find any specific provisions addressing the settlement of employees' arrears when a company went into provisional supervision. The arrangements seem to vary from place to place, depending on whether there are other supporting benefits exist for the unemployed and the social/welfare/labour conditions in those respective economies. For example, in the US Bankruptcy Code Chapter 11 and Japan's Corporate Reorganisation Act 1952, outstanding wages of former employees of a company undergoing an equivalent statutory rescue scheme are normally treated as a priority debt (subject to certain limits) in a rescue plan[2]. The UK Insolvency Act 1986 provides that the preferential debts of employees, which are similar to those in section 265 of the CO, must be given priority in a company voluntary arrangement unless the preferential creditors agree otherwise.

Employees' debts as priority debts (Option D)

28. The question arises as to whether we could follow the practice in other jurisdictions, that is, to accord priority to employees' debts in a rescue plan. The main drawback in this arrangement is that the employees might have to wait a long time, ranging from 30 days to 6 months or more before it is known whether there would be a rescue plan. This might create financial hardship to employees in the interim period.

29. The alternative will be to allow these employees to first seek relief from the PWIF, which will then seek 100% repayment from the company as a priority debt in a rescue plan of the company in provisional supervision. Under this arrangement, the obligation to pay still rests with the employer, but allowing employees to have quicker relief. The requirement that the payment so made out by the PWIF be treated as a priority debt in a voluntary arrangement plan will ensure that the PWIF have a higher chance to recoup the funds. If the company went from provisional supervision into liquidation eventually, the PWIF would have its ordinary subrogation rights in respect of employees in accordance with the provisions of the Ordinance.

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[2] or, as "administrative claims" in the case of Japan which has to be paid before priority claims in a rescue plan.

30. Under the option, the PWIF will have to shoulder at least initially the financial costs of paying off employees of companies that went into provisional supervision. In other words, this would have constituted a fundamental change in the use of the Fund. In addition, similar to Option A, any additional funding needed to maintain the health of the PWIF would have to come from an upward adjustment of the annual $250 levy, although the magnitude of the increase of the PWIF levy may be somewhat smaller depending on the success of the PWIF in securing recourse. In addition, given that this payment so made has to be treated as a priority debt, it may take longer time for the major creditors to reach an agreement on a voluntary arrangement, if any.

31. It is recognised that Option D is in effect very similar to Option A in the sense that it would also be tantamount to granting a loan to bail out the company whilst the latter remains a going concern during provisional supervision. This may turn the PWIF into a "Corporate Rescue Fund" and hence represents a fundamental change to the purpose for which the PWIF was set up. The only difference is the provision of allowing PWIF to seek 100% repayment from the company as a priority debt in a rescue plan of the company afterwards. The essence of this arrangement is to tie the financially-troubled company over the short term liquidity problem which it might be facing.

32. It must be further pointed out that like Options A and C, Option D will also not be able to resolve the problems as identified in paragraphs 10 & 11 above relating to the incompatibilities with the EO and the concern over potential abuse by unscrupulous employers who may try to evade their statutory responsibilities under the disguise of corporate rescue. In such circumstances, these employers will stand to benefit from the PWIF at the expense of the legitimate interests of those employees of genuinely insolvent employers which the PWIF is intended to protect.

Summary of options

Option A - PWIF to pay (LRC proposal)

- **immediately widen the ambit of the Protection of Wages on Insolvency Ordinance to accommodate employees affected by provisional supervision.**

Option B - employer to pay in full prior to initiating corporate rescue

- **to require the company to clear all arrears of wages before it undergoes corporate rescue.**

Option C - to exempt all employees from the moratorium

- **Employees not bound by the moratorium and may petition anytime to the court for its winding up. PWIF to pay upon presentation of a winding-up petition against the company by employees but the company may, instead of being wound up, continue as a going concern under corporate rescue.**

Option D - PWIF to pay first, then seek 100% recourse from the company as a priority debt in a voluntary arrangement

- **Widen the ambit of PWIF to allow employees get quick relief but simultaneously require that payment so made by PWIF be treated as a priority debt in a voluntary arrangement plan of the company.**

The Way Forward

33. We welcome views on the above four options. Any other suggestions on how to deal with the debts owed to employees by a company undergoing corporate rescue are also welcome. Please send your comments to Financial Services Bureau, 18/F, Admiralty Centre Tower 1, 18 Harcourt Road, Hong Kong for the attention of Assistant Secretary for Financial Services (Companies (1)) by 28 February 1999.

Financial Services Bureau
21 December 1998
Ref.: C2/1/11/1C(98)
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Annex C

Legislative Council
Panel for Financial Affairs

Report on consultation on Proposed
Statutory Procedures for Corporate Rescue

Introduction

This paper reports to Members on the results of Government's consultation exercise on the Law Reform Commission's ("LRC") proposal of using the Protection of Wages on Insolvency Fund ("PWIF") to accommodate claims of employees who are laid off by companies entering into corporate rescue and inform Members of the Administration's stance on the way forward.

Recommendation

2. We propose to proceed with drafting legislation to provide for statutory corporate rescue in Hong Kong, with a condition that the company undergoing corporate rescue must be responsible for clearing all arrears of wages, severance pay and other statutory entitlement of its employees as if it is a going concern.

Background and Argument

The LRC recommendations

3. The LRC proposed in its Report in October 1996 that Hong Kong should have a statutory corporate rescue procedure which provides a 30-day moratorium for viable businesses to try to reach a voluntary arrangement with their creditors so that the company concerned can continue as a going concern, in whole or in part, thus saving it from going straight into liquidation. During the moratorium, creditors cannot petition to the court for a winding up order against the company.

4. Recognizing that the employees of the company who are laid off by the company undergoing corporate rescue (also known as provisional supervision) might be cut out and left without the prospect of getting an interim payment from the PWIF, the LRC suggested that the PWIF should

be used to meet the outstanding claims of those employees who are laid off by a company under provisional supervision. Specifically, this would mean that the PWIF would need to be extended to cover the outstanding arrears of wages, severance pay and other statutory entitlement of the following categories of employees laid off by the company during the "relevant period" ((a) and (b) below) –

(a) before the initiation of corporate rescue; and

(b) in the first 14 days of corporate rescue, whereby their employment contracts are not accepted by the provisional supervisor under the LRC proposal.

The need for public consultation

5. In the course of implementing the LRC proposal, we identified some incompatibilities between the LRC's proposal, and the Employment Ordinance ("EO") and Protection of Wages on Insolvency Ordinance ("PWIO"), regarding the rights of employees. In view of the controversy and conflicting interests inherent in the LRC proposal, we considered it necessary to conduct a public consultation exercise to gauge the views of the various interested parties, in particular the employers' and the employees' organizations, the banking and financial sectors and practitioners who are involved in corporate rescue. We would like to take into account their views before we formulate the Administration's stance on the matter.

Public consultation and results

6. The public consultation period lasted from 22 December 1998 to 31 March 1999. Our consultation paper put forward four options for parties to comment, namely –

<u>Option A</u>: the LRC proposal as set out in paragraph 4 above;

<u>Option B</u>: The company must clear all arrears/statutory entitlement of employees that it laid off during the relevant period;

<u>Option C</u>: Exempting employees from the moratorium so that their right to petition to wind up the company would be preserved; and this would enable employees to make a claim on the PWIF upon the presentation of a winding up petition; and

Option D: PWIF to pay the employees first if they are laid off during the relevant period and the full amount to be recouped from the company as priority debt in a voluntary arrangement among creditors.

In total, we have received 26 submissions. A list of the respondents is at Annex.

7. We briefed the Legislative Council Panel on Financial Affairs and Panel on Manpower jointly on 1 February 1999. Views expressed at the Panel meeting were fairly divided. Some members expressed concern over whether employees' rights would be compromised under the proposed scheme. Some considered that the LRC proposal – with some modification – should be workable, whilst others expressed support for option D.

8. Among the 26 submissions, views received were diametrically opposite. Representative bodies of those who are most directly affected by the proposed rescue procedures namely, employers and employees were unanimously against all four options. They were strongly against any change in the use of the PWIF, notwithstanding their pledge of "in principle" support for the concept of corporate rescue.

9. There is widespread concern among the employer/employee sectors that there were no effective safeguards of the rescue scheme against possible abuses: namely (a) the moratorium may allow the non-viable business to delay repayment at the expense of creditors; (b) unscrupulous employers may first lay off employees and then evade the statutory responsibility of paying arrears of wages/entitlements to these employees by passing the burden to the PWIF. They considered that the PWIF should not be the vehicle for financing the proposed corporate rescue. Both the Labour Advisory Board and the PWIF Board expressed strong reservation on making use of the PWIF to bail out private corporations and implement the proposed corporate rescue scheme.

10. There was also concern that small and medium enterprises (SMEs) were unlikely to benefit from the proposed corporate rescue scheme. The professional fees to be incurred in a corporate rescue would put the proposed regime beyond the reach of average SMEs.

11. As for the insolvency professionals and practitioners who are involved in a corporate rescue, they were broadly in favour of Option A or with some modification as they believed this to be the only workable option. They considered that the concerns about possible abuse were either not well-founded or could be satisfactorily dealt with. The financial sector supported Option D

as they considered this to be the fairest or most practicable option and that employees would not be prejudiced. There was marginal support for Options B and C.

Analysis of the Results

12. The consultation reveals that neither employers nor employees see any benefit in extending the use of PWIF to statutory corporate rescue. This has in effect closed the door for Options A, C and D referred to in paragraph 6 above.

13. Some respondents suggest that we should consider setting up a separate "corporate rescue fund". Funding for this option would be a major consideration. The business sector will be against any increase in the cost of doing business. We are also mindful that any subsidy by Government towards such a new fund will invite criticisms that tax-payers are made to bail out businesses.

Proposed option

14. The above analysis prompted us to revisit Option B, under which the company undergoing corporate rescue must be responsible for clearing all arrears of wages, severance pay and other statutory entitlement of its employees <u>as if it is a going concern.</u>

15. The merits of this option are –

(a) employee's rights are fully protected in line with existing labour legislation;

(b) it does not involve the PWIF in its operation;

(c) it does not require any contribution from the tax-payers or increase in the $250 PWIF levy or business registration fee for the creation of a new fund; and

(d) it would help remove opportunities for possible abuse of PWIF or any new fund in the course of corporate rescue.

16. One of the key conditions laid down by the LRC for extending the statutory procedures of corporate rescue to a company is that it must be a <u>viable</u> business worth rescuing. We understand from the market that the requirement under this option would be an effective tool to screen out the non-viable

companies which should not have been qualified for statutory corporate rescue in the first place. According to market sources, the clients of most informal "work-outs" at present are public companies listed in Hong Kong with a market capitalization of $100 million - $150 million. Given their size, potentially viable companies undergoing corporate rescue are expected to be able to pay their employees. As these payments are not significant compared with the debts owed by the companies, they would unlikely pose any material impact on the success of a work-out. The more likely situation was that if a company could not even pay his employees, it should cast serious doubts on whether a corporate rescue scheme would likely succeed.

17. We believe that this option will provide an additional safeguard against possible evasion of statutory obligations towards employees by unscrupulous employers through corporate rescue. Under the LRC proposal, in the first 14 days of the rescue, the provisional supervisor has the option to accept/not to accept employment contracts that are in force immediately before the initiation of corporate rescue. In other words, the provisional supervisor may lay off (some) employees in order to rescue the company and the laying off exercise would be financed by the PWIF. Under our recommended option, any laying off exercise will be financed by the assets of the company coming into the hands of the provisional supervisor. This would help ensure that the lay-off is cost-effective and kept to an optimal scale.

Gate-Keeping Role of the Provisional Supervisor

18. Some respondents have expressed concern about the gate-keeping role to be performed by the provisional supervisor who will decide whether a company is viable and hence worth rescuing, and whose advice the Court would rely upon heavily in deciding whether the 30-day moratorium should be extended.

19. We appreciate the concern. If we are to introduce statutory corporate rescue, we should pay particular attention to the need for adequate checks and balances to ensure proper gate-keeping by the provisional supervisor to ensure that only viable businesses should be allowed to be rescued, and that the moratorium should not be used by non-viable companies to delay repayment.

The Way Forward

20. On balance, we suggest that we should modify the LRC proposal and adopt the prudent approach of requiring a company undergoing corporate rescue to be responsible for clearing all arrears of wages, severance pay and other statutory entitlement of its employees as if it is a going concern. We

realize that this modification would make the company rescue operation to be conducted by a provisional supervisor more challenging than under the LRC proposal, but at least we would be able to allow the new scheme to make a start.

21. The scheme would be a first step to improve the existing voluntary corporate rescue procedures, and provide a meaningful statutory option for really viable businesses to continue operating. It would enable practitioners to build up the required expertise and experience, as well as the community to test the system for possible abuse. It would also allow the scheme to build up a good track record, and earn sufficient public confidence and respect for any possible expansion.

22. Our intention now is to complete the draft legislation and submit it to the Legislative Council for consideration in the 1999/2000 Legislative Session.

Financial Services Bureau
2 June 1999

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<u>Annex</u>

List of Organisations which commented on
the Consultation Paper on Corporate Rescue
and the Protection of Wages on Insolvency Fund
(Treatment of Employees in Provisional Supervision)

<u>Chinese General Chamber of Commerce</u>

Chinese Gold and Silver Exchange Society
Chinese Manufacturers' Association of Hong Kong
Consumer Council
DTC Association
Emirates Bank International
Employers' Federation of Hong Kong
Federation of Hong Kong & Kowloon Labour Union
Federation of Hong Kong Industries
Hong Kong Association of Banks
Hong Kong Bar Association
Hong Kong Chamber of Small and Medium Business Limited
Hong Kong Coalition of Service Industries
Hong Kong Federation of Insurers
Hong Kong Federation of Trade Unions
Hong Kong Futures Exchange Limited
Hong Kong General Chamber of Commerce
Hong Kong Institute of Company Secretaries
Hong Kong Retail Management Association
Hong Kong Society of Accountants
Labour Advisory Board
Law Society of Hong Kong
Lingnan College
Protection of Wages on Insolvency Fund Board
Securities and Futures Commission
Stock Exchange of Hong Kong

Total: 26

Annex D

Summary of the provisions
in the Companies (Amendment) Bill 2000
related to the proposed statutory
corporate rescue procedure

1. Clause 24 adds the new Part IVB to give effect to the proposals on corporate rescue procedure.

2. The new section 168V specifies the categories of companies to which corporate rescue shall/shall not apply. The new sections 168W and 168X empowers the Official Receiver to appoint a panel of professional accountants and solicitors eligible for appointment as provisional supervisors. The directors or a liquidator of the company may appoint a provisional supervisor under the new section 168Y.

3. The new section 168ZA to 168ZC set out the filing and notification requirements in respect of the notice of appointment of the provisional supervisor. The Notice has to include a 'consent to act' form duly signed by the provisional supervisor. The form will be prescribed by the Official Receiver who will require, amongst other matters, the level of remuneration of the provisional supervisor to be displayed prominently in the consent form for creditors to be so informed in the first instance. In addition, the Notice will require the company to confirm that it has set aside sufficient money to settle the statutory liabilities owed to its employees and former employees under the Employment Ordinance (Cap. 57) before the company goes into provisional supervision.

4. The new section 168 ZD sets out the effects of moratorium and the exemptions to it. The new section 168ZE provides for extensions to the moratorium subject to the sanction of the court.

5. The duties and powers of the provisional supervisor are set out in

the new sections 168ZF and 168ZG, and the new Eighteenth Schedule. Powers of directors are to be suspended under the new section 168ZI and the provisional supervisor will act as an agent of the company.

6. The new sections 168ZJ and 168ZK specify the liability of the provisional supervisor vis-à-vis contracts of goods and services and contracts of employment entered into before and after the rescue. Where the provisional supervisor accepts a pre-existing contract of employment, or enters into a new contract of employment, the wages and salaries thereby payable have priority over the provisional supervisor's remuneration. The provisional supervisor is indemnified out of the property of the company for all debts for which he is liable under the new section 168ZL.

7. Under the new section 168ZM, the provisional supervisor is remunerated in accordance with a scale of fees approved by the Official Receiver. The court, on the application of the provisional supervisor, may vary the scale. Creditors may also object if they consider the fees to be excessive.

8. Under the new section 168ZN the provisional supervisor is required to prepare a statement of affairs of the company as soon as practicable. The procedures for the removal and resignation of the provisional supervisor are set out in the new section 168ZO.

9. The creation of 'super' priority debt is in the new section 168ZP. Borrowings made by the company in provisional supervision will receive priority over all existing debts, with the exception of fixed charges. This is necessary because in all likelihood, a company under rescue would need to raise capital to fund its operations during the provisional supervision period.

10. The new section 168ZQ sets out the procedures for major creditors of the company to decide whether or not the provisional supervisor may proceed to prepare the proposal. If a major creditor refuses,

then the moratorium ceases and the provisional supervisor vacates his office. If the major creditors agree to the drawing up of a proposal but the proposal is eventually rejected by the creditors, the company may either be wound up as a creditors' voluntary winding-up, or if it was previously under court winding-up procedures, the stayed procedures would be re-activated.

11. The new sections 168ZR to 168ZT set out the requirements and procedures for the creditors’ meetings to consider the proposal by the provisional supervisor. Where the proposal is accepted by the creditors, a voluntary arrangement will follow and the procedures for such an arrangement are in the new sections 168ZU to 168ZY.

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