LC Paper No. CB(1)2073/00-01(01)

The Administration's Comments on
Submissions on the Companies (Corporate Rescue) Bill

(8 submissions — LC Paper Nos. CB(1)2027/00-01(01) to (08))

Submission from the Hong Kong Democratic Foundation

We note the objection of the Hong Kong Democratic Foundation to the proposals set out in the Companies (Corporate Rescue) Bill, but wish to reiterate that the need for the proposed corporate rescue procedure has been thoroughly considered by the Law Reform Commission (LRC). Indeed it is after wide public consultation on the matter that the LRC has recommended a corporate rescue procedure for companies in financial difficulty.

2. We have accepted the LRC's recommendation, having regard to the possible benefits of such a procedure to the shareholders, creditors, and employees of a company in financial difficulty. Contrary to what the Hong Kong Democratic Foundation suggested, the proposed corporate rescue procedure is not complex. The Bill sets out the procedure in detail, with a view to ensuring transparency and guarding against any possible abuse. The duties of the proposed provisional supervisor are also clearly set out in the Bill as he will play a key role in a corporate rescue exercise.

Submission from the Employers' Federation of Hong Kong

3. We note that the Employers' Federation of Hong Kong has no objection to the proposal of introducing corporate rescue provision to Hong Kong. We also note its position that the welfare of the employees concerned should be secured with preference and that the Protection of Wages on Insolvency Fund (PWIF) be operated within its current framework and objectives.

Submission from the Labour Advisory Board

4. We note that the Labour Advisory Board supports the present proposals in the Bill.

Submission from Lingnan University

5. We note that Lingnan University is in principle supportive of the corporate rescue concept. As regards its various points about the provisions in the Bill, we have the following comments –

(a) the Bill contains adequate provisions about the qualifications and appointment of provisional supervisors as well as the monitoring of their work. In brief, they are selected from a panel of practitioners operated by the Official Receiver, and are accountants or legal professionals with good experience in corporate rescue and insolvency matters. Under the Bill, any voluntary arrangement proposal put forward by the provisional supervisor needs the approval of the majority of the creditors before it can be implemented. Moreover, if the creditors are not satisfied with the performance of the provisional supervisor, they can apply to the court for his removal;

(b) we do not consider it necessary to pre-set the qualifications of the persons to whom a provisional supervisor may delegate his duties and powers under the Bill as the provisional supervisor would, notwithstanding the delegation, be the person ultimately responsible for the acts of such persons;

(c) the proposed moratorium will not apply to the proceedings under section 168A of the Companies Ordinance because we consider it necessary to preserve the rights of minority shareholders under that section to petition to the court for alternative remedies to winding-up; and

(d) the Bill does not require a voluntary arrangement to be approved by a unanimous vote of all the creditors, though it preserves the rights of a secured creditor to deal with his security. It is possible for a secured creditor to stay out of a voluntary arrangement that has been approved by other creditors.

Submission from the PWIF Board

6. We note that the PWIF Board supports in principle the spirit and concept of the proposed corporate rescue scheme and consider the proposals in the Bill would be to the benefit of the workforce in Hong Kong and would have a positive impact on the financial position of the PWIF. We also note that the PWIF welcomes the proposed provisions relating to the treatment of the wage liabilities owed by a company to its employees and reiterates its objection to the proposal of adding in flexibility to the trust account requirement in the Bill.

Submission from the Consumer Council

7. We note that the Consumer Council supports in principle the proposed corporate rescue procedure. As regards its concern about publicity on the operations of a corporate rescue exercise, the appointment of the provisional supervisor and the commencement of the corporate rescue procedure will be announced in the Gazette as well as in the newspapers. We also note the concerns of the Consumer Council about the interests of unwary consumers, but do not consider it appropriate for the Bill to require the setting up of a trust account to cater for payment towards prepaid coupons.

Submission from the Chinese General Chamber of Commerce

8. On the points raised by the Chinese General Chamber of Commerce, we have the following comments –

(a) although the initial period of the proposed moratorium is 30 days, the provisional supervisor can apply to the court for its extension up to six months. Thereafter, any extension will be subject to the agreement of the creditors of the company;

(b) as explained in paragraph 5(a) above, the Bill contains adequate provisions about the qualifications and appointment of provisional supervisors as well as the monitoring of their work. As regards the remuneration of provisional supervisors, it will be determined in accordance with a scale of fees approved in writing by the Official Receiver. Provisional supervisors may not charge fees higher than the approved scale of fees unless with the court's sanction. Creditors may apply to the court to reduce the remuneration;

(c) we note the position of the Chamber on the proposal of adding in flexibility to the trust account requirement; and

(d) the LRC has considered Chapter 11 of the US Bankruptcy Code and concluded that it is not suitable for Hong Kong.

Submission from PricewaterhouseCoopers

9. PricewtaerhouseCoopers argues against the treatment of the employees under the provisions in the Bill and in particular questions the trust account requirement. It also advocates the use of the PWIF in the proposed corporate rescue procedure. We wish to reiterate that the provisions relating to the trust account requirement have been drafted, having regard to the outcome of wide public consultation on the matter and trying to balance the interests of all the relevant parties. The LegCo Panel on Financial Affairs was briefed on the rationale behind our proposals on 5 February 2001. A copy of the relevant discussion paper is attached.

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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