BY FAX (2869 6794) AND BY HAND

Clerk to Bills Committee on Companies (Corporate Rescue) Bill
Legislative Council Secretariat
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3 Garden Road, Central
HONG KONG

For the attention of Ms Rosalind Ma

8 November 2001

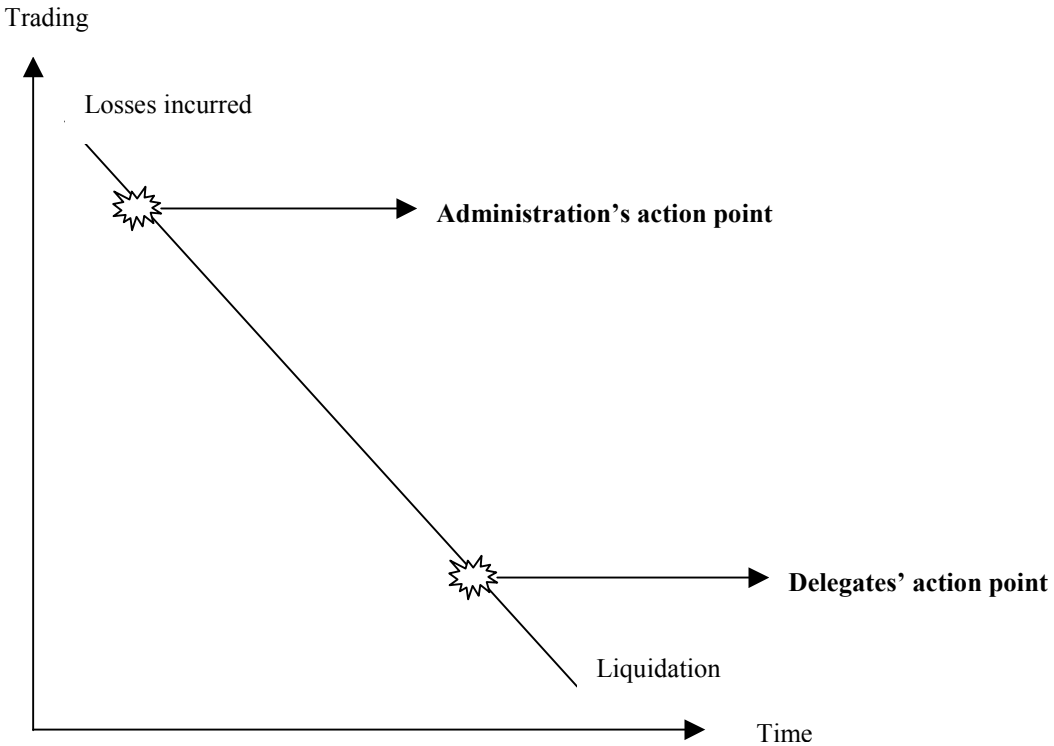
Our Ref: DRH.RJH/

Dear Madam

COMPANIES (CORPORATE RESCUE) BILL

I refer to my submission dated 7 September 2001 and to the oral submissions made by various parties on 22 October 2001. I note that it was very helpful to hear the broad variety of views of interested parties and thank the Bills Committee for the opportunity to further address concerns raised.

One of the areas in which the Administration, the Members and the Delegates may differ is their assessment of the position at which a company may seek protection through Provisional Supervision ("PS"). To put this in context, it may be helpful to look at a typical insolvency curve. There are many different forms of this curve, but in very simple terms:



The early stages are typically characterised by 1 or 2 quarters of loses. The exact shape of the curve and how quickly a company slides down it vary considerably, depending on a variety of factors. The end of the line however is liquidation.

From the arguments put forward it seems that the Administration, and some of the members, envisage action being taken at an early stage, when indeed the company may still have sufficient resources to set up a Trust Fund for the benefit of employees.

In my experience, directors generally seek assistance only at the last possible moment. In Australia, for example, there has been a raft of cases of appointments of a Voluntary Administrator (similar to a PS) being appointed the night before a winding up petition is due to be heard. By this time the company has almost invariably defaulted on its banking provisions and has either run out of or is running out of cash. One of the Members, Ms Audrey Eu, summed up the situation well when she said that directors were generally the most optimistic about their prospects and were unlikely to heed the advice of their professional advisers until the very end, if at all. The proposed insolvent trading legislation with the penalties envisaged should help to encourage earlier decision making by the directors, (i.e. to move the 'action point' up the curve).

The various delegates clearly envisage the appointment of a PS taking place only 1 or 2 steps before liquidation, at which point the immediate full payment of employee provisions becomes difficult or impossible.

It might be helpful to outline the views expressed by the parties at the meeting on 22 October. Broadly, these can be divided into the categories below:

1. The Administration

- Protect employees rights by payment of entitlements in full before PS is appointed.
- Limits on preferential payments from liquidation is irrelevant.
- If that means companies go into liquidation possibly unnecessarily and employees lose their jobs as a consequence of an unworkable system, so be it.
- There should be no distinction between the rights of directors and the rights of other employees to be paid in full before a PS is appointed.

2. The Members

- A work out plan funded by employees wages is no work out plan at all.
- Is Hong Kong the only jurisdiction with such comprehensive protection of employees? Is there any reason why Hong Kong employees need to be protected more than their counterparts overseas?
- Directors are generally the most optimistic about the chances of their company's success.

3. The Delegates

- A number of companies appointing a PS will go into liquidation (e.g. in UK and Australia over 50% of companies in Voluntary Arrangements/Administration go into liquidation).
- The requirement of payment in full will mean that employees receive more than they would have been entitled to in liquidation.
- It will also mean that other creditors receive less than they would have been entitled to in liquidation, especially in a company with highly paid or numerous employees.
- Unscrupulous directors could use this requirement to pay themselves to the detriment of other creditors.
- Employees jobs are more important to them than guaranteed payment for a short time (e.g. Ansett).
- Employees employed by management companies (a common occurrence) would have no protection at all – an inequitable result.
- There is no suggestion that the work out plan itself (i.e. the voluntary arrangement) should be funded by employees wages – only that in the short moratorium period the ongoing viability of the company should be given first priority.
- Hong Kong would be the only jurisdiction in the world to require such a high level of protection of employees.
- It is agreed that the directors are generally the most optimistic about their company's success – this leads to help being sought at the last possible moment – usually when they have run out of cash.

4. The Compromise (Messrs Smart & Booth)

- Option A – protect employees preferential status to the same extent as liquidation, to be paid immediately from a voluntary arrangement.
- Option B – all employee debts to be paid immediately from a voluntary arrangement.

As discussed in my submission on 7 September 2001, my view is that the best way to protect employees is through the Protection of Wages on Insolvency Fund (the "Fund"). The two arguments against this appear to be that:

1. the proposal would alter fundamentally the nature and policy intent of the Fund; and
2. PS would increase the Fund's financial burden.

Firstly, whilst I do not agree that the proposal would fundamentally alter the nature and intent of the Fund, I also cannot see why this should matter.

Secondly, appropriate arrangements could be made to financially protect the Fund. Voluntary Arrangements will only be accepted by creditors if returns are better than those under liquidation. Companies which do not go into a Voluntary Arrangement will likely have to be placed in liquidation and the Fund will have to pay anyway. For companies that are successful with a Voluntary Arrangement, the Fund is likely to recoup more money from PS rather than increasing the financial burden on the Fund.

If the Fund is not an option, we should consider the proposals of Messrs Smart and Booth. Option A would do much to alleviate creditors concerns that PS and liquidation should offer the same protection to employees. I think as Messrs Smart and Booth themselves imply, this is not an ideal solution as the company will have to come up with cash – fast. However, the compromise offered is, in my opinion, a better alternative than the current draft legislation.

Also raised by the Hong Kong Association of Banks at the meeting was the issue of control by major creditors of the PS process. At present the major secured creditor can only veto the appointment after it is made. Allowing a major secured creditor the option to veto the appointment of a PS before the appointment is made may partially address the Association's concerns and save expense if the major secured creditor is unable to support the appointment.

Should you require any further information, please do not hesitate to contact me on 2289 8822.

Yours faithfully

David Hague
Partner