

**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 wound 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 ascertained, 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.