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Panel on Financial Affairs
Special meeting on 19 July 2010

Background brief on
Review of corporate rescue procedure legislative proposals

Purpose

This paper sets out the background of the review of corporate rescue procedure legislative proposals and summarizes Members' views and concerns expressed on the subject during the scrutiny of the Companies (Amendment) Bill 2000 and the Companies (Corporate Rescue) Bill in 2001, and during the meeting of the Panel on Financial Affairs (FA Panel) held on 7 December 2009.

Background

2. At present, Hong Kong companies facing financial difficulty may try to come to an arrangement with their creditors by means of non-statutory voluntary workouts or restructuring arrangements under section 166 of the Companies Ordinance (CO) (Cap. 32). Neither of those methods provides for a moratorium that can bind creditors while an arrangement proposal is being formulated, thereby lacking certainty. There have also been complaints that schemes of arrangement are complex and require too much court involvement. While the court has shown flexibility in some cases by allowing provisional liquidation procedures under section 193 of the CO, where there is a moratorium in place, to be used to facilitate corporate rescue, the court has made clear that section 193 is not intended for initiating corporate rescue.

3. The Law Reform Commission (LRC) recommended in 1996 the introduction of a statutory corporate rescue procedure in the form of "provisional supervision" whereby a moratorium on legal action would be provided to a company in financial difficulty. LRC recommended the appointment of an independent professional third party, the provisional supervisor, to take effective control of the company during the provisional supervision period and to formulate a voluntary arrangement proposal for creditors within a specified timeframe. In addition, LRC also recommended introducing "insolvent trading" provisions to encourage directors and senior

management to act on insolvency earlier rather than later by making them personally liable for debts of a company which traded while insolvent.

The Companies (Amendment) Bill 2000

4. The legislative proposals to implement LRC's recommendation on corporate rescue procedure were part of the Companies (Amendment) Bill 2000, which was introduced into the Legislative Council (LegCo) on 19 January 2000. Members of that Bills Committee were generally in support of the rationale behind the corporate rescue and insolvency trading proposals. 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. These members were concerned that the Bill did not provide flexibility in this regard. They 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 proposed legislative provisions.

5. The Bills Committee suggested that the Administration should consult the Labour Advisory Board (LAB) on the proposal to provide some flexibility to the requirement to settle all arrears due and owed by the company to its employees. Having regard to the time constraint and complexity of the legislative proposals, the Bills Committee recommended that the corporate rescue proposals be excised from the Bill and be fine-tuned for re-submission to LegCo at a later stage.

The Companies (Corporate Rescue) Bill in 2001

6. After consulting LAB and the Protection of Wages on Insolvency Fund (PWIF) Board, the Administration proposed in February 2001 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. The Administration also proposed that certain legislative proposals be revised to take into account the views expressed in the submissions of various professional bodies and trade organizations made to the Bills Committee on Companies (Amendment) Bill 2000. The Administration introduced the Companies (Corporate Rescue) Bill into LegCo on 18 May 2001.

7. Members of the Bills Committee on the Companies (Corporate Rescue) Bill supported the concept of corporate rescue, but expressed doubts about the proposed requirement that, before the commencement of the corporate rescue procedure, either all outstanding wages and liabilities of employees had to be paid or sufficient funds must be provided for in a trust account for the purpose. Members were concerned that as there was no ceiling for such amounts, it was unlikely that a company in financial difficulty would have sufficient money to fulfill the requirement. This

requirement might therefore create a substantial obstacle to the commencement of corporate rescue procedure, thus defeating the purpose of the Bill. To address the members' concern, the Administration had proposed that the sum payable to each employee would be capped, and informed the Bills Committee that it would consult the relevant parties on the new proposal.

8. The Administration was also requested to review whether it was appropriate to hold the directors and senior management of a company liable for insolvent trading. Some Members considered that this provision would create practical difficulties and discourage people from being directors and responsible persons of companies. The Bills Committee decided that the scrutiny of the Bill should be held in abeyance to allow time for the Administration to conduct consultation on, and work out the details of, new proposals. Due to the complexity of the legislative proposals and diverse views among stakeholders, the Bill was not enacted and lapsed at the end of the second term of LegCo ending 2004.

Review of corporate rescue procedure in 2009

9. The corporate rescue and insolvent trading proposals were originally scheduled to be reviewed as part of the Phase Two CO rewrite exercise. With the onset of the global financial crisis and the likely increase in companies facing financial difficulties, the Administration announced in January 2009 that it would adopt the recommendation of the Task Force on Economic Challenges to re-consider the introduction of a corporate rescue procedure, ahead of the schedule of the Phase Two CO rewrite.

10. In re-examining the corporate rescue procedure, the Administration has taken into account the following principles:

- (a) Provisional supervision should complement, and not replace, existing restructuring arrangements under the CO and non-statutory arrangements;
- (b) Court involvement should be minimized so as to save costs and time;
- (c) Employees should generally be no worse off than in the case of insolvent liquidation; and
- (d) Consideration should be given to allowing greater involvement of creditors in the rescue process in exchange for their being bound by the moratorium once the process commences and the rescue plan is agreed.

11. On 29 October 2009, the Administration launched a three-month public consultation on the conceptual framework and key issues relating to corporate rescue.

A diagrammatic illustration of the proposed operation of provisional supervision is given in the **Appendix**¹.

Deliberations of the Panel on Financial Affairs in December 2009

12. The Administration briefed the FA Panel on the corporate rescue procedure proposals on 7 December 2009. Some members expressed concern that the proposed corporate rescue procedure, under which a company or its directors or provisional liquidators or liquidators may initiate provisional supervision by appointing a provisional supervisor, was too costly for small and medium-sized enterprises (SMEs) in financial difficulty. The Administration responded that while SMEs in financial difficulty might be relatively less likely to benefit from the proposed corporate rescue procedure, the proposed procedure aimed to provide an option to bridge the gap of the existing statutory and non-statutory arrangements for companies to survive through financial difficulty. The provisional supervision and the moratorium proposed under the corporate rescue procedure would improve the chances of survival of corporations, as more time would be allowed for the provisional supervisors to work out the voluntary arrangement proposal for approval of the creditors. Preliminary consultation with the business sector indicated that the corporate rescue procedure could help corporations to tide over difficulties during financial crisis.

13. Some members expressed concern about the protection for employees' interests under the proposed corporate rescue procedure, as it was quite common for corporations in liquidation to owe to their employees considerable amount of arrears of wages, severance payments and other statutory entitlements. The Administration responded that it was consulting the public on various options to settle employees' outstanding entitlements, including the proposal put forward in 2003 of capping the trust account amount to mirror that of the Protection of Wages on Insolvency Fund. The Administration assured members that employees' interests would be protected under the proposed corporate rescue procedure by ensuring that their entitlements and rights would not be worse off than in the case of winding up. As the provisional supervisor to be appointed to work out the voluntary arrangement for corporate rescue would be unconnected with the board of directors/management of the corporation concerned, the possibility of abuse by employers or company directors would be minimized.

Latest position

14. The Administration will brief the FA Panel at the meeting on 19 July 2010 on the public feedback on the corporate rescue legislative proposals and the way forward.

¹ The diagram in the **Appendix** is reproduced from Chapter 1 of the Administration's consultation paper on "Review of Corporate Rescue Procedure Legislative Proposals" published on 29 October 2009.

Relevant papers

15. Relevant papers are available at the following links:

Information note on introduction of statutory corporate rescue procedure in Hong Kong — report on consultation on the proposed flexibility on the settlement of outstanding wages and other entitlements

<http://www.legco.gov.hk/yr00-01/english/panels/fa/papers/a522e03.pdf>

LegCo Brief on Companies (Corporate Rescue) Bill

http://www.legco.gov.hk/yr00-01/english/bc/bc12/general/b40_brf.pdf

Minutes of House Committee meeting on 7 December 2001 (paragraphs 45 to 48)

<http://www.legco.gov.hk/yr01-02/english/hc/minutes/hc011207.pdf>

Hon Paul CHAN's question on corporate rescue procedure raised at the Council meeting on 13 May 2009

<http://www.info.gov.hk/gia/general/200905/13/P200905130151.htm>

Information note on public consultation on the review of corporate rescue procedure legislative proposals

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/facb1-191-1-e.pdf>

Minutes of FA Panel meeting on 7 December 2009

<http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20091207.pdf>

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