

**The Legislative Council
Panel on Financial Affairs**

Follow-up to Special Meeting on 19 July 2010

Review of Corporate Rescue Procedure Legislative Proposals

**Public Views Received on the
Proposal to Introduce Insolvent Trading Provisions**

In response to the Clerk to Panel's letter dated 20 July 2010, this paper provides information on the public views on the proposal to introduce insolvent trading provisions received during the public consultation on the "Review of Corporate Rescue Procedure Legislative Proposals".

2. We received a total of 59 submissions in response to the consultation paper entitled "Review of Corporate Rescue Procedure Legislative Proposals". Among them, 41 submissions commented on the proposal to introduce insolvent trading provisions (which was set out in Chapter 6 therein). A copy of the relevant chapter of the consultation paper is at **Annex A**. A summary of the public views received on the insolvent trading proposal is at **Annex B**.

3. Full copies of the submissions received are available at the Financial Services Branch's website.¹ The consultation conclusions are also available at the above website.

**Financial Services Branch
Financial Services and the Treasury Bureau
9 August 2010**

¹ Available at http://www.fstb.gov.hk/fsb/topical/review_crplp.htm.

CHAPTER 6

INSOLVENT TRADING

Background

6.1 In the 2001 Bill, in order to encourage directors and senior management to act on insolvency earlier rather than later, they would be made personally liable for the debts of a company which traded while insolvent. The liquidator of a company would be empowered to make an application to the court to seek a declaration that a “responsible person” was liable for insolvent trading when a company went into liquidation. Under the 2001 Bill, a “responsible person” was defined as a director, a shadow director or a member of senior management. The grounds on which the court might declare a “responsible person” liable for insolvent trading were as follows:

- (1) (a) the responsible persons **knew or ought reasonably to have known** the company was insolvent or **knew or ought reasonably to have known** that there was no reasonable prospect that the company could avoid becoming insolvent; or
 - (b) there were **reasonable grounds for suspecting** that the company was insolvent or there was no reasonable prospect that the company could avoid becoming insolvent,

and

- (2) the responsible persons failed to take any steps to prevent the insolvent trading.

6.2 The insolvent trading provisions were intended to be applicable to companies in general and not only in the context of provisional supervision. However, these provisions would in effect serve as an incentive to induce responsible persons to initiate provisional supervision earlier, rather than resorting to insolvent trading before liquidation.

6.3 During scrutiny of the 2001 Bill, some stakeholders from the business sector expressed concerns that the insolvent trading provision would discourage directors and senior management from taking any risk and would not be conducive to business operations.

6.4 Having reviewed this issue, and having made reference to the regimes in other jurisdictions,² we remain of the view that some form of insolvent trading provision is needed to complement provisional supervision by encouraging directors to act on insolvency earlier rather than later to prevent further erosion of the distressed company's assets at the detriment of creditors.

Proposals

6.5 To address the business sector's concerns, we **propose** two adjustments to the insolvent trading provision:

- (a) *Excluding senior management from being liable under insolvent trading.* Notwithstanding the LRC's recommendation in this regard (see paragraph 1.5 above), we consider that there will unavoidably be questions as to who is a "senior manager". We have also made reference to the insolvent or wrongful trading provisions in other major common law jurisdictions, such as Australia and the UK, and note that the relevant provisions in those jurisdictions do not cover senior managers. We therefore consider it appropriate to retain liability for directors (including shadow directors), while exempting senior management from being liable for insolvent trading; and
- (b) *Modifying the standard in establishing liability.* Among the grounds to establish liability for insolvent trading as set out in paragraph 6.1 above, we **propose** dropping ground (1)(b) to impose a higher standard in establishing liability so as to address the business sector's concerns. As a result, responsible persons will only be held liable if they **knew or ought reasonably to have known** the company was insolvent or **knew or ought reasonably to have known** that there was no reasonable prospect that the company could avoid becoming insolvent. A reasonable suspicion of the company's insolvency will not suffice.

Question 15

Do you support the introduction of insolvent trading provisions? In case you do not, please explain and suggest alternatives to (a) encourage timely initiation of provisional supervision; and (b) deter irresponsible depletion of the company's assets.

² UK's "wrongful trading" provisions and Australia's "insolvent trading" provisions.

Question 16

Do you agree with the proposed revised formulation of “insolvent trading”?
If not, please suggest alternatives.

Review of Corporate Rescue Procedure Legislative Proposals

Public Views Received on the Proposal to Introduce Insolvent Trading Provisions

A. Submissions which supported the introduction of insolvent trading provisions

(1) *Submissions which agreed with our proposed adjustments as presented in the consultation paper*

Respondents*	
<i>Organisations:</i>	
● Borrelli Walsh Limited	● DBS Bank (Hong Kong) Limited
● British Chamber of Commerce in Hong Kong, The	● Deloitte Touche Tohmatsu
● Canadian Certified General Accountants Association of Hong Kong	● Hong Kong Bar Association
● CCIF Corporate Advisory Services Limited	● Hong Kong Federation of Insurers, The
● Chartered Institute of Management Accountants	● Hong Kong Institute of Certified Public Accountants
● Chinese General Chamber of Commerce, The	● Hong Kong Institute of Directors, The
● Chinese Manufacturers' Association of Hong Kong, The	● Hong Kong Securities Association
● CITIC Ka Wah Bank Limited	● Mazars CPA Limited
	● PricewaterhouseCoopers
<i>Individuals:</i>	
● Dr Garry J HAMILTON	
● William M. F. WONG	

* Listed according to the alphabetical order of the names (organisations) and the surnames (individuals) of the respondents.

Respondents
<p><u>Respondents who requested anonymity:</u></p> <ul style="list-style-type: none">● Three submissions <p>Sub-total: 22</p>

A. Submissions which supported the introduction of insolvent trading provisions

(2) *Submissions which agreed with our proposed adjustments as presented in the consultation paper and which made further suggestions*

Respondents	Specific Views
<p><u>Organisations</u></p> <ul style="list-style-type: none"> ● Allen & Overy ● Gall & Lane Dispute Resolution Lawyers Hong Kong ● Hong Kong Association of Banks, The ● Hong Kong General Chamber of Commerce ● Hong Kong Institute of Chartered Secretaries, The ● Law Society of Hong Kong, The 	<p><u>Allen and Overy</u></p> <ul style="list-style-type: none"> ● Directors who act reasonably and honestly should have a defence to liability for insolvent trading. <p><u>Gall & Lane Dispute Resolution Lawyers Hong Kong</u></p> <ul style="list-style-type: none"> ● Given the difficulties in establishing who “a responsible person” is, an alternative is to adopt the “dishonest” test under section 275 of the Companies Ordinance. ● The “insolvent trading” provisions should be extended to the holding company of a subsidiary who has the control over the management of the subsidiary’s affairs. <p><u>Hong Kong Association of Banks, The</u></p> <ul style="list-style-type: none"> ● If senior management is to be excluded, there should be a corresponding increase in the duties on the part of the directors, for example by imposing a positive onus to make enquiries as regards the financial position and prospects of the company. <p><u>Hong Kong General Chamber of Commerce</u></p> <ul style="list-style-type: none"> ● Directors who act reasonably and honestly should have a defence to liability for insolvent trading.

Respondents	Specific Views
<p><u>Individual:</u></p> <ul style="list-style-type: none"> ● Rupert PURSER <p><u>Respondent who requested anonymity:</u></p> <ul style="list-style-type: none"> ● One submission <p>Sub-total: 8</p>	<p><u>Hong Kong Institute of Chartered Secretaries, The</u></p> <ul style="list-style-type: none"> ● Directors should not be held liable for honest errors of commercial judgment. Absent an element of dishonesty, directors and officers should not be held responsible for debts of creditors. <p><u>Rupert PURSER</u></p> <ul style="list-style-type: none"> ● The legislation should state that a company's lenders and financiers when in provisional supervision are excluded from the definition of shadow directors. <p><u>Law Society of Hong Kong, The</u></p> <ul style="list-style-type: none"> ● A clearer definition of “insolvent trading” is needed to avoid ambiguity. <p><u>Respondent who requested anonymity</u></p> <ul style="list-style-type: none"> ● The formulation needs to specify whether a debt must be incurred at the time the director or shadow director engages in the insolvent trading for the duty to arise. ● A defence should be expressly available as in the UK legislation, to the effect that if the director or shadow director took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken, no breach of duty would arise.

A. Submissions which supported the introduction of insolvent trading provisions

(3) *Submissions which did not agree with our proposed adjustments as presented in the consultation paper*

Respondents	Specific Views
<p><u>Organisations:</u></p> <ul style="list-style-type: none"> ● Australasian Compliance Institute ● Consumer Council ● CPA Australia Limited ● Ferrier Hodgson Limited ● Grant Thornton <p><u>Individuals:</u></p> <ul style="list-style-type: none"> ● Angus YOUNG and Tina CHU <p>Sub-total: 6</p>	<p><u>Australasian Compliance Institute / Angus YOUNG and Tina CHU</u></p> <ul style="list-style-type: none"> ● It is crucial for Hong Kong to have a provision in imposing a “positive duty” on directors to prevent insolvent trading as opposed to focusing on each particular debt with individual complex examinations for creditor's recovery. ● Opposed to the proposed removal of (1)(b) because it would seriously weaken the operability of (2) to act as a preventive mechanism. ● The word “any” in subsection (2) should be replaced by “all”. <p><u>Consumer Council</u></p> <ul style="list-style-type: none"> ● The proposed adjustment may run the risk of weakening the deterrent effect on irresponsible trade practices. ● The proposed adjustment may lower the incentive of the corporate to initiate provisional supervision earlier. ● The 2001 provisions should be retained as the 2001 provisions will be more conducive to proper conduct of business and achieving the legislative objective; and thereby afford more protection to consumers. ● It is important to alert pre-paying consumers about the fact, nature and effect of provisional supervision so that consumers can make informed decision.

Respondents	Specific Views
	<p data-bbox="586 252 896 288"><u>CPA Australia Ltd.</u></p> <ul data-bbox="586 300 2027 770" style="list-style-type: none"> <li data-bbox="586 300 2027 432">● At least while a company is subject to provisional supervision, directors’ personal guarantees should not be allowed to be enforced against the directors (without leave of the Court) where they relate to company liabilities. <li data-bbox="586 443 2027 528">● Australian insolvent trading regime, by providing a narrow form of corporate veil piercing, is an important mechanism for avoiding abuses of limited liability and the corporate form. <li data-bbox="586 539 2027 671">● Our view is to impose lower threshold in establishing insolvent liability by keeping the ground (1)(b). We should not underestimate that the corporate governance and collar crimes are one of the major issues we face today. <li data-bbox="586 683 2027 770">● The statutory wording of the Australian insolvent trading regime more closely accords with the ground (1)(b). <p data-bbox="586 831 990 868"><u>Ferrier Hodgson Limited</u></p> <ul data-bbox="586 879 2027 1206" style="list-style-type: none"> <li data-bbox="586 879 2027 1011">● The definition of a shadow director should be wide enough to capture a person who is not formally appointed as a director but who act in a position of a director or in accordance with the company's directors are accustomed to act. <li data-bbox="586 1023 2027 1206">● The proposed modification of the standard in establishing liability should not occur, i.e. (1)(b) should not be deleted. On its own, (1)(a) is only a weak deterrent to insolvent trading and that the intention of the insolvent trading provisions will be better served by including (1)(b).

Respondents	Specific Views
	<p data-bbox="586 252 851 288"><u>Grant Thornton</u></p> <ul data-bbox="586 308 2027 635" style="list-style-type: none"> <li data-bbox="586 308 2027 443">● Some suitable form of reference to “senior management” should be retained, as “shadow director” per se may not be wide enough to “catch” people who ought reasonably to have known the company was insolvent. <li data-bbox="586 451 2027 635">● There should be express provision that “senior management” will exclude professional advisors engaged by the company or any individual director during the PS process, including the provisional supervisor as well as those lenders who usually are also likely to be actively involved throughout the restructuring process.

B. Submissions which did not support the introduction of insolvent trading provisions

Respondents	Specific Views
<p><u>Organisations</u></p> <ul style="list-style-type: none"> ● Federation of Hong Kong Industries ● Hong Kong Small and Medium Enterprises Association ● Institute of Accountants in Management, The ● K K Yeung Management Consultants Limited ● Society of Chinese Accountants & Auditors, The <p>Sub-total: 5</p>	<p><u>Federation of Hong Kong Industries</u></p> <ul style="list-style-type: none"> ● It is difficult to devise an objective and clear formulation of “insolvent trading”. Faced with unpredictable enforcement standards, company directors will certainly be overcautious in running businesses as they want to avoid running up debts unnecessarily, and the enterprising spirit of our business community may thus be undermined. ● Holding directors personally responsible for company debts through legislation is against the spirit of “limited company”, and will even dampen the incentives for starting businesses and making investment, indirectly undermining Hong Kong’s ability to create jobs. ● Business operation cannot be entirely risk-free. SMEs, with weaker cash flow positions, may become insolvent because of sudden cancellations by buyers of certain transactions of huge amounts and not through their own fault. This was very common during the financial tsunami earlier. Should the Government legislate to hold directors personally responsible for company debts, such insolvent companies will probably have no choice but to close down and many people will become unemployed. ● Under section 275 of the Companies Ordinance, company directors shall be personally responsible for debts resulting from fraudulent trading. This should be sufficient to protect the interests of creditors. <p><u>Hong Kong Small and Medium Enterprises Association</u></p> <ul style="list-style-type: none"> ● Most of the SMEs in Hong Kong operate on a domestic or family basis with more than one family member serving as company directors. If a company continues to operate in the

Respondents	Specific Views
	<p>expectation of a turnaround in business and the court subsequently holds the directors liable, a number of family members will be implicated. Such an impact will be too great for the parties concerned to bear.</p> <ul style="list-style-type: none"> ● This arrangement will have far-reaching implications for the operation of SMEs and dampen the incentives for SMEs to start businesses. ● The laws of Hong Kong allow companies to operate with \$1 share capital. Such companies have been relying on funding by directors or from external loans. They will not be able to fully cover their operating expenses if the sales of goods/services are not satisfactory. Under such circumstances, should the directors continue or cease business in order to avoid such liability? ● Unless the term “going concern” is clearly and unambiguously defined, legislating for this is undesirable. <p><u>Institute of Accountants in Management, The</u></p> <ul style="list-style-type: none"> ● The issue should be considered in the special business environment of Hong Kong wherein most, in terms of numbers, of the enterprises are SME’s. ● Failure of companies may not be owing to the greed or incompetence of the directors or senior managers of the SME’s or the financially depressed companies. It could be owing to the uncontrollable external business and financial environments. ● To impose penalty on the directors or senior managers in the cases of failed companies may not gain the support of the financial and business sectors. ● Until and unless there are more criminal cases of conspiracy to defraud committed by directors and senior managers in the failure of companies, it is too early, at this stage, to

Respondents	Specific Views
	<p>introduce penalties on directors and senior managers involved in insolvency trading.</p> <ul style="list-style-type: none"> ● Another survey could be conducted on this single topic to consolidate the views of the commercial sectors and other related parties. <p><u>K K Yeung Management Consultants Limited</u></p> <ul style="list-style-type: none"> ● The Company Ordinance has already prevented directors from over trading and duplicated efforts should be avoided. ● The directors should be encouraged to act on insolvency earlier in other different ways e.g. education in cooperation with bodies like Institute of Directors and some other recognised professional accountancy bodies. <p><u>Society of Chinese Accountants & Auditors, The</u></p> <ul style="list-style-type: none"> ● Companies incorporated under share capital of HK\$1 are immediately deemed insolvent for their next transaction like engaging staff or renting on office space. ● The wording of “took <u>reasonable</u> step” rather than “took <u>every</u> step with a view to minimizing the potential loss to the company’s creditors as he ought to have taken” in the old bill should be used.