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Panel on Financial Affairs
Meeting on 3 May 2013

Updated background brief on review of corporate insolvency law

Purpose

This paper provides background information on the Administration's review of the corporate insolvency law regime. It also summarizes views and concerns expressed by members on the subject at the meetings of the Panel on Financial Affairs ("FA Panel") held in 2009, 2010 and 2011.

Review of the corporate insolvency law regime

2. Currently, the statutory provisions relating to Hong Kong's corporate insolvency law regime are principally contained in the Companies Ordinance (Cap. 32) ("CO"). The Administration launched a comprehensive rewrite of the CO in mid-2006. Due to the extensive nature of the CO rewrite, a phased approach was adopted by tackling the provisions which affected the operation of the live companies in Hong Kong through the introduction of the Companies Bill into the Legislative Council ("LegCo") on 26 January 2011. The Companies Bill was enacted as the new CO on 12 July 2012. The winding-up and insolvency-related provisions in the exiting CO will be dealt with under the improvement of corporate insolvency law exercise. When the new CO comes into operation, the provisions concerning the operation of live companies in the existing CO will be repealed and the remaining provisions, including the winding-up and insolvency provisions will be re-titled as the Companies (Winding Up and Miscellaneous Provisions) Ordinance.

3. According to the Administration, the underlying objectives of the improvement of corporate insolvency law exercise are threefold, namely-

(a) to streamline and rationalize the company winding-up procedures having regard to international experience with a view to facilitating more efficient administration of winding-up and increasing protection of creditors;

(b) to provide for a new statutory corporate rescue procedure for companies in short-term financial difficulty to turn around or restructure; and

(c) to enhance regulation of the winding-up regime and insolvency practitioners[1].

4. Having regard to the above objectives, the Administration conducted an initial scoping exercise to identify some of the issues to be addressed for improvement of the corporate insolvency law. A list of the preliminary proposals is set out in **Appendix I**.

5. The Administration plans to launch a public consultation in 2013 on the major legislative proposals to improve the corporate insolvency regime and introduce a bill to amend the Companies (Winding Up and Miscellaneous Provisions) Ordinance into LegCo within the 2012-2016 LegCo term.

Administration's efforts in providing a new statutory corporate rescue procedure

6. 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 CO. Neither of these methods provides for a moratorium that can bind creditors while an arrangement proposal is being formulated, thereby lacking certainty.

7. In 1996, the Law Reform Commission ("LRC") recommended the introduction of a statutory corporate rescue procedure in the form of "provisional supervision" to provide a moratorium on legal action to a company in financial difficulty, and "insolvent trading" provisions to encourage directors and senior management to act on insolvency earlier. These legislative

[1] The Administration will also take the opportunity to follow up on, where appropriate, the technical recommendations of the "Report on the Winding-up Provisions of the Companies Ordinance" issued by the LRC in 1999.

proposals were incorporated as part of the Companies (Amendment) Bill 2000 which was introduced into LegCo on 19 January 2000. As the Bills Committee on the Bill considered that the Administration should consult the Labour Advisory Board ("LAB") on the proposal to provide flexibility on the requirement for a financially troubled company to settle all arrears due and owed by the company to its employees as if it were a going concern, and having regard to time constraint and complexity of the legislative proposals on corporate rescue, the Bills Committee recommended that the relevant provisions be removed from the Bill and fine-tuned for re-submission to LegCo at a later stage.

8. After consulting LAB and other stakeholders, the Administration proposed 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. The Administration introduced the Companies (Corporate Rescue) Bill into LegCo on 18 May 2001. During the scrutiny of the Bill, members expressed concern that as no ceilings were proposed on the amount of outstanding wages and liabilities of employees to be paid by a company or the amount of fund to be kept in a trust account for this purpose, it was doubtful if a company in financial difficulty could fulfill the requirement before commencing the corporate rescue procedure. There was also concern about the appropriateness to hold the directors and senior management of a company liable for insolvent trading. The Administration was requested to review these issues. The Bills Committee latter decided that the scrutiny of the Bill should be held in abeyance to allow time for the Administration to conduct consultation on the 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.

9. On 29 October 2009, the Administration launched a three-month public consultation on the conceptual framework and key issues relating to corporate rescue[2]. The consultation conclusions on the review were issued in July 2010[3]. Since then, the Administration has been working on the detailed proposals of the statutory corporate rescue procedure and the plan is to take forward these proposals in the improvement of corporate insolvency law exercise.

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[2] The consultation paper is available at http://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp_e.pdf.

[3] The consultation conclusions are available at http://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp_conclusions_e.pdf.

Major concerns/views expressed by members of the Panel on Financial Affairs

10. The Administration briefed the FA Panel on the legislative proposals on the corporate rescue procedures put forward in the public consultation conducted in 2009 and the feedbacks and conclusions of the consultation at meetings on 7 December 2009 and 19 July 2010. The FA Panel also discussed the Administration's plan to modernize the corporate insolvency law at the meeting on 7 November 2011. The ensuing paragraphs summarize the major views and concerns raised by members at these meetings.

Provisional supervision as a new statutory corporate rescue procedure

11. Despite there were merits to introduce a statutory corporate rescue procedure in Hong Kong by placing a moratorium on legal action on a company in financial difficulty to assist it to turn around and continue to operate, some members expressed concern that the procedure would be costly for small and medium-sized enterprises ("SMEs") in financial difficulty. The Administration responded that the proposed corporate rescue 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 while SMEs in financial difficulty might be relatively less likely to benefit from the procedure. The provisional supervision and the moratorium proposed under the 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.

12. Some members opined that certain financially troubled companies might not be suitable to pursue the rescue procedure and enquired whether a threshold would be set for a company to initiate the corporate rescue procedure, such as the need for seeking a court order. The Administration responded that the corporate rescue procedure provided an alternative arrangement to rescue insolvent companies. There was no intention to set any restriction on the types of companies which might seek to initiate the corporate rescue procedure (except those companies which were subject to other regulatory regimes, e.g. banks).

13. There was concern about whether the provisional supervision arrangement would be adequate for protecting creditors' interests. It was noted that as in the United States, appointment of a trustee would be required to oversee the operation of the company when a company pursued the corporate

rescue procedure. Some members suggested that apart from the support of secured creditors, consideration should be given to seeking the support of non-secured creditors for the corporate rescue procedure to continue after initiation, as non-secured creditors would be most affected by the liquidation of the company concerned. The Administration explained that based on the recommendation of LRC, the corporate rescue procedure could only be continued with the concurrence of the major secured creditors. A meeting of the creditors would be held after commencement of the corporate rescue procedure to consider the suitability of the appointment of the provisional supervisor, who would be personally liable for debts and liabilities under certain conditions.

14. On the concern that some multi-national corporations facing insolvency might arrange transfer of their capital out of Hong Kong before initiating the corporate rescue procedure, the Administration advised there was legislation in Hong Kong and other jurisdictions to enable the liquidators to challenge the transfer of property to other overseas branch offices of an insolvent corporation before liquidation, i.e. the anti-avoidance provisions. The proposed insolvent trading provisions would hold those who abused credit and the availability of credit to account in this regard.

Proposed insolvent trading provisions

15. Some members were concerned that the business community had yet to reach a consensus on the proposed corporate rescue procedure, and expressed reservation over including insolvent trading provisions in the procedure to empower the liquidator of a company to make an application to the court for seeking a declaration that a "responsible person" (i.e. a director or a shadow director) who failed to prevent the insolvent trading was personally liable for the debts of a company which traded while insolvent. They pointed out that a director would face a dilemma when a limited company became insolvent. If the director declared that his company was insolvent, banks would be reluctant to provide credit facility for the company. If the director did not disclose the insolvency, he would be personally liable for insolvent trading. There was also concern that the insolvent trading provisions might place unfair responsibilities on the directors of corporations. These members stressed the need for the Administration to consider the proposal on insolvent trading carefully.

16. The Administration advised that the insolvent trading provisions were modeled on similar arrangements in other jurisdictions including Australia and the United Kingdom. The provisions aimed to encourage directors to act on insolvency earlier and to enhance corporate governance. Only if the directors continued the business of the company without taking steps to prevent insolvent

trading, would they be liable, under civil proceedings, for the debts of the company incurred during the insolvent period. Taking into account the views of the respondents expressed during public consultation, the standard in establishing liability had been modified by dropping the ground of "reasonable grounds for suspecting", and other defence factors for the directors might be considered during the drafting of the legislative provisions. The liquidator of a company would consider factors such as the cost involved and the repayment ability of the director(s) concerned before making an application to the court.

Protection for employees' interests

17. There were concerns about the protection for employees' interests under the proposed corporate rescue procedure, in particular the treatment for employees' arrears of wages, severance payments and other outstanding 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 the proposed corporate rescue procedure aimed to ensure employees' 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.

18. A member expressed concern about the high level of fees charged by Official Receiver ("OR") in individual insolvency cases which might dent into the dividends available for distribution to creditors, and urged that there should be provisions to regulate the amount of fees charged by OR. The Administration advised that the Government had from time to time reviewed the fee scale for insolvency cases. A person who felt aggrieved regarding the fee charged by OR for a bankruptcy case could seek redress from the court. The subsidiary legislation relating to the scale of fees to be charged for insolvency cases would also be reviewed during the exercise to improve the corporate insolvency law.

Latest Development

19. The Administration published a consultation document on "Improvement of Corporate Insolvency Law Legislative Proposals" on 16 April 2013 for a three-month consultation up to 15 July 2013. The Administration will consult Panel members on the legislative proposals to improve corporate insolvency law at the meeting on 3 May 2013.

Relevant papers

20. A list of the relevant papers on the LegCo website is in **Appendix II**.

Council Business Division
Legislative Council Secretariat
30 April 2013

Appendix I

Preliminary List of Proposals under the Corporate Insolvency Law Modernization Exercise

	Proposal and objective	Overseas Comparison
Streamlining and Rationalizing Company Winding-up Procedures		
1.	Updating the existing provision on "unfair preference" (i.e. sections 266, 266A and 266B of the Companies Ordinance (CO) where the court may void payments made by an insolvent company preferring a particular creditor to other creditors) by making it a self-contained provision without the cross-reference to the provisions of the Bankruptcy Ordinance, including amending the definition of the term "associate" to cater for corporate insolvency.	Both the United Kingdom (UK) and Australia have standalone unfair preference provisions for corporate insolvency
2.	Introducing a new provision on "transactions at an undervalue" to enable the court to unwind transactions made by a company prior to liquidation for which the company received no consideration, or for a consideration which is significantly less than the actual value of the subject of the transaction.	The UK has provisions on transaction at undervalue and Australia has provisions on uncommercial transactions.
3.	Replacing the existing time and cost consuming process of taxation of costs of liquidators' agents in a compulsory liquidation by that of agreement with the committee of inspection, or in the absence of such a committee or agreement, by the court.	Unless agreed between the liquidator and the agent, the remuneration of the liquidator's agents in the UK must be decided by detailed assessment. In Australia, such remuneration does not need to be approved by the committee of inspection, creditors or the court but it may be reviewed by the court on an application of a person aggrieved.

	Proposal and objective	Overseas Comparison
4.	Embracing new technology by allowing the committee of inspection to perform its duties and functions (such as holding meetings) by using electronic means, and allowing the liquidators to communicate with creditors, contributories and other interested parties by way of electronic means of communication.	The meetings of creditors and liquidation committee can be held by electronic means in the UK and by using telephone conference facilities in Australia. Office-holders in the UK and Australia can serve notices or send documents required by law by electronic means or use of a website.
5.	Rewriting section 265 of the CO, which sets out the classes of creditors which are accorded preferential status in the payment out of the assets of a company. Section 265 was amended in piece-meal fashion over the years, with each exercise focusing on its own particular issue.	When rewriting section 265, reference will be made to insolvency laws in other jurisdictions which also have provisions governing payment of certain debts in priority to all other unsecured debts in the winding up of a company (e.g. the UK and Australia).
6.	Reviewing and rationalizing the definition of and relevant provisions concerning liquidators (particularly with reference to its meaning in relation to provisional liquidators), and clarifying the basis of calculation of remuneration of provisional liquidators.	Reference will be made to the practices in overseas jurisdictions when reviewing the provisions in Hong Kong.
7.	Introducing a number of technical amendments to rationalize the existing statute and to bring it in line with international practices and developments, such as: (i) combining section 190(4) of the CO and rule 43 of the Companies (Winding-up) Rules as both provisions deal with the costs of preparation of statement of affairs; and	Reference will be made to the relevant provisions in the insolvency laws of overseas jurisdictions. (i) There is a provision governing the costs of preparation of statement of affairs in respect of court winding-up in both Australia and the UK.

	Proposal and objective	Overseas Comparison
	(ii) allowing members of committees of inspection to claim their reasonable traveling expenses to and from meetings of committees, limited to expenses incurred in Hong Kong.	(ii) Such expenses are considered as liquidation expenses in the UK while in Australia, they are one of the priority payments that has priority over other unsecured debts.
Providing for a new Statutory Corporate Rescue Procedure		
8.	(i) Introducing a corporate rescue procedure called "provisional supervision" whereby a moratorium on legal action would be provided to a company in financial difficulty to assist the company to turn around and continue to operate as going concern	Corporate rescue procedures also exist in the UK, Australia and Singapore.
	(ii) In order to encourage directors to act on insolvency earlier rather than later, introducing insolvent trading provisions so that the liquidator of a company would be empowered to make an application to the court to seek a declaration that a "responsible person" (i.e. a director or a shadow director) who failed to prevent the insolvent trading was personally liable to pay compensation which may cover the debts of a company which traded while insolvent.	Both the UK and Australia have provisions which make directors liable for insolvent trading.
Enhancing Regulation		
9.	Reviewing existing provisions on the qualification and disqualification of liquidators and provisional liquidators with a view to considering the possibility of introducing new comprehensive provisions to ensure the quality of liquidators/provisional liquidators and avoiding conflict of interest situations.	Both the UK and Australia have qualification requirements for liquidators and provisional liquidators.

	Proposal and objective	Overseas Comparison
10.	Reviewing and rationalizing provisions for the procedures and effect relating to the death, resignation, removal and release of liquidators and provisional liquidators.	In the UK and Australia, there are specific provisions regarding the removal, resignation, release and filling of vacancy of office of liquidators. In the UK, there are also provisions for the termination of appointment of provisional liquidators.
11.	Reviewing the existing special procedure for voluntary winding up of company initiated by directors in case of inability to continue its business (section 228A of the CO).	There is no similar provision in the UK or Australia.
12.	Providing that, notwithstanding a liquidator has been released, it should not absolve him from the provisions of section 276 of the CO which provide the court with the power to assess damages against a delinquent liquidator.	In the UK, there is a provision specifying that the release does not prevent an application for summary remedy against the delinquent liquidator. In Australia, a release order may be revoked if it is proved that it was obtained by fraud, suppression or concealment of any material facts.

[Source: Annex A to Administration's paper on "Modernization of Corporate Insolvency Law (LC Paper No. CB(1)237/11-12(05))]

Appendix II

List of relevant papers

Date	Event	Paper/Minutes of meeting
7 December 2009	Meeting of the Panel on Financial Affairs ("FA Panel")	Information note on "Public Consultation on the Review of Corporate Rescue Procedure Legislative Proposals" (with copy of the consultation paper on "Review of Corporate Rescue Procedure Legislative Proposals" issued by the Administration in October 2009) (LC Paper No. CB(1)191/09-10(01)) http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/facb1-191-1-e.pdf Minutes (LC Paper No. CB(1)976/09-10) http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20091207.pdf
19 July 2010	Meeting of the FA Panel	Administration's paper (enclosing the consultation conclusions on "Review of Corporate Rescue Procedure Legislative Proposals" released in July 2010) (LC Paper No. CB(1)2525/09-10(03)) http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0719cb1-2525-3-e.pdf Minutes (LC Paper No. CB(1)2933/09-10) http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20100719.pdf
7 November 2011	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)237/11-12(05)) http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa1107cb1-237-5-e.pdf Minutes (LC Paper No. CB(1)614/11-12) http://www.legco.gov.hk/yr11-12/english/panels/fa/minutes/fa20111107.pdf

Date	Event	Paper/Minutes of meeting
16 April 2013	Launching of a three-month public consultation on "Improvement of Corporate Insolvency Law Legislative Proposals"	Public consultation document (LC Paper No. CB(1)867/12-13(01) http://www.legco.gov.hk/yr12-13/english/panels/fa/papers/fa0503cb1-867-1-e.pdf Administration's paper on "Improvement of Corporate Insolvency Law" (LC Paper No. CB(1)876/12-13(01)) http://www.legco.gov.hk/yr12-13/english/panels/fa/papers/fa0503cb1-876-1-e.pdf