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Panel on Financial Affairs
Meeting on 7 July 2014

**Updated background brief on review of corporate insolvency law and
introduction of a statutory corporate rescue procedure**

Purpose

This paper provides background information on the Administration's review of the corporate insolvency law regime and proposal to introduce a new statutory corporate rescue procedure ("CRP"). It also summarizes views and concerns expressed by Members on the subject at the meetings of the committees of the Legislative Council ("LegCo") held between 2009 and 2014.

Review of the corporate insolvency law regime

2. The statutory provisions relating to Hong Kong's corporate insolvency law regime are principally contained in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)¹ ("C(WUMP)O"). In November 2011, the Administration rolled out a legislative exercise to modernize Hong Kong's corporate insolvency law regime, and conducted a three-month public consultation exercise from April to July 2013 on a package of 46 legislative proposals to improve the insolvency and winding-up provisions. The underlying objectives of the improvement exercise are to facilitate more efficient administration of the winding-up process; and increase protection of creditors through streamlining and rationalizing the company winding-up procedures and enhancing regulation of the winding-up process, having regard

¹ When the new Companies Ordinance ("new CO") (Cap. 622) which contains provisions concerning the operation of live companies commenced operation on 3 March 2014, the old CO with the winding-up and insolvency provisions was re-titled as C(WUMP)O.

to international experience. The legislative proposals cover the following five aspects –

- (a) commencement of winding-up;
- (b) appointment, powers, vacation of office and release of provisional liquidators and liquidators;
- (c) conduct of winding-up;
- (d) voidable transactions; and
- (e) investigation during winding-up, offences antecedent to or in the course of winding-up and powers of the court.

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

3. At present, Hong Kong companies that are in financial difficulty have various options for going forward, such as coming to a non-statutory arrangement with their creditors, coming to a compromise or arrangement under the relevant legislation, or effecting a corporate restructuring by a provisional liquidator.

4. In 1996, the Law Reform Commission ("LRC") recommended the introduction of a statutory CRP called "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 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 CRP, 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.

5. 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 CRP. 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.

6. On 29 October 2009, the Administration launched a three-month public consultation on the conceptual framework and key issues relating to introduction of provisional supervision as a CRP in Hong Kong. The consultation covered a number of issues, namely, initiation of provisional supervision, moratorium, employees' outstanding entitlements, provisional supervisor, insolvent trading, secured creditors, and voting at meetings of creditors.

7. The consultation conclusions were published in July 2010. According to the Administration, the majority of respondents submissions received during the consultation indicated general support for many of the proposals. Nevertheless, there are a few proposals that drew disparate views from stakeholder groups. The Administration aimed to develop a package of detailed legislative proposals for further engagement with stakeholders in 2014.

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

8. The Administration briefed the Panel on Financial Affairs ("FA Panel") on the legislative proposals on CRP put forward in the 2009 public consultation exercise 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 improve the corporate insolvency law and related legislative proposals at the meetings on 7 November 2011 and 3 May 2013. On 6 January 2014, the Administration consulted the FA Panel on a staffing proposal to retain two supernumerary directorate posts in the Financial Services and the Treasury Bureau to spearhead legislative initiatives relating to, amongst

others, corporate insolvency. The staffing proposal was considered at the meeting of the Establishment Subcommittee on 19 February 2014. The ensuing paragraphs summarize the major views and concerns raised by Members at these meetings.

Improvement of corporate insolvency law

Procedure under section 228A of the old Companies Ordinance

9. Members expressed concerns about safeguards for abuse of the special procedure set out in section 228A of the old CO (i.e. "the section 228A procedure"). Under the procedure, if the directors, or a majority of the directors, had formed the opinion that the company could not by reason of its liabilities continue its business, they might resolve at a meeting of the directors and deliver to the Registrar of Companies ("the Registrar") a winding-up statement to the effect that the company could not by reason of its liabilities continue its business and should be wound up (i.e. the winding-up statement").

10. The Administration advised that to address possible abuse of the section 228A procedure, it was proposed that the winding-up statement must state that the directors' meeting in question had been convened. This would ensure that members of the company would be made aware of the directors' initiation of the section 228A procedure at the earliest possible instance. Moreover, the winding-up statement would require the appointment of a provisional liquidator to take effect upon delivery of the statement to the Registrar. There would also be restriction on the power of the provisional liquidator.

11. On members' enquiry about whether there was a mechanism for shareholders to object or halt the section 228A procedure, the Administration pointed out that allowing reversal of the section 228A procedure might give rise to complications in the restoration of the position of the company before the winding-up. In this connection, a proposal was included in the consultation document to seek public views on whether the section 228A procedure should be maintained or repealed.

Employee protection and consultation with labour groups

12. Some Members stressed the need to gauge the views of the labour sector on issues such as the order of priority for employees in the list of creditors, treatment of consignment transaction, and the current arrangement of using the accrued benefits of employers' contributions to Mandatory Provident Fund ("MPF") schemes for offsetting Severance Payment or Long Service

Payment ("SP/LSP offsetting arrangement") payable to employees as this would affect the settlement of employees' outstanding entitlements by the insolvent company. The Administration advised that it had consulted various stakeholders, including the labour unions, during the public consultation on the legislative proposals to improve the corporate insolvency law. On the SP/LSP offsetting arrangement, the Administration considered that the matter should be dealt with separately in the context of improvement of the Mandatory Provident System.

Consistency between corporate insolvency and personal bankruptcy provisions

13. There was a view that the Administration should maintain the consistency between provisions on corporate insolvency and winding-up and those for personal bankruptcy proceedings under the Bankruptcy Ordinance (Cap. 6) ("BO"). The Administration advised that it had made reference to the personal bankruptcy provisions when proposing similar provisions in the corporate insolvency law. For example, the proposal to introduce new provisions on transactions at an undervalue was modelled on similar provisions in the existing personal bankruptcy regime.

Corporate Rescue

Timeframe for introducing a statutory corporate rescue procedure

14. Noting the merits of a CRP for companies over the winding-up procedure to minimize adverse impacts on the relevant parties (e.g. creditors and employees of a company), as well as general support of the business sector for a CRP, some Members urged the Administration to take forward the legislative proposals early. The Administration advised that its plan was to develop a package of detailed legislative proposals for engagement with stakeholders in 2014. Subject to the outcome of the consultation, the Administration would consider including provisions on CRP in the same amendment bill for improving the corporate insolvency law. In the event that the stakeholders could not reach a consensus on the proposed CRP regime and further deliberation was required, the legislative exercise for introducing CRP would be taken forward separately.

Provisional supervision and moratorium

15. Some Members expressed concern that it would be costly for small and medium-sized enterprises ("SMEs") in financial difficulty to pursue the statutory CRP. The Administration responded that the proposed CRP 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 chance 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 CRP could help corporations to tide over difficulties during financial crisis.

16. Some Members opined that certain financially troubled companies might not be suitable to pursue CRP and enquired whether a threshold would be set for a company to initiate the procedure, such as the need for seeking a court order. The Administration responded that CRP 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 CRP (except those companies which were subject to other regulatory regimes, e.g. banks).

17. 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 CRP. Some members suggested that apart from the support of secured creditors, consideration should be given to seeking the support of non-secured creditors for CRP 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, CRP could only be continued with the concurrence of the major secured creditors. A meeting of the creditors would be held after commencement of CRP to consider the suitability of the appointment of the provisional supervisor, who would be personally liable for debts and liabilities under certain conditions.

18. On the concern that some multi-national corporations facing insolvency might arrange transfer of their capital out of Hong Kong before initiating CRP, the Administration advised that 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

19. Some Members expressed reservation over including insolvent trading provisions in CRP 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.

20. 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

21. As regards the protection for employees' interests under the proposed CRP, in particular the treatment for employees' arrears of wages, severance payments and other outstanding statutory entitlements, the Administration responded that it would consult 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 CRP 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.

Latest Development

22. On 28 May 2014, the Administration published the conclusions of the public consultation on the corporate insolvency law improvement exercise and the detailed proposals for introducing a new statutory CRP and insolvent trading provisions. The Administration will brief the FA Panel on the matters at the meeting on 7 July 2014.

Relevant papers

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

Council Business Division
Legislative Council Secretariat
4 July 2014

List of relevant papers

Date	Event	Paper/Minutes of meeting
13 May 2009	Council meeting	Question raised by Hon Paul CHAN on "Corporate rescue procedure" (pages 47-56)
7 December 2009	Meeting of the Panel on Financial Affairs ("FA Panel")	Information paper 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)) Minutes (LC Paper No. CB(1)976/09-10)
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)) Minutes (LC Paper No. CB(1)2933/09-10)
7 November 2011	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)237/11-12(05)) Minutes (LC Paper No. CB(1)614/11-12)

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)) Administration' paper on "Improvement of Corporate Insolvency Law" (LC Paper No. CB(1)876/12-13(01))
3 May 2013	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)876/12-13(01)) Updated background brief (LC Paper No. CB(1)929/12-13(06)) Minutes (LC Paper No. CB(1)1789/12-13)
6 January 2014	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)625/13-14(08)) Background brief (LC Paper No. CB(1)625/13-14(09)) Minutes (LC Paper No. CB(1)1310/13-14)
19 February 2014	Meeting of the Establishment Subcommittee	Administration's paper (EC(2013-14)23) Minutes (LC Paper No. ESC43/13-14)