File Ref: C2/1/12C(99)IX

LEGISLATIVE COUNCIL BRIEF

Companies Ordinance
(Chapter 32)

COMPANIES (AMENDMENT) BILL 2000

INTRODUCTION

At the meeting of the Executive Council on 4 January 2000, the Council ADVISED and the Acting Chief Executive ORDERED that the Companies (Amendment) Bill 2000, at Annex A, should be introduced into the Legislative Council.

BACKGROUND AND ARGUMENT

The Law Reform Commission's Report on "Corporate Rescue and Insolvent Trading"

2. At present, Hong Kong companies that run into financial difficulties may try to come to a voluntary arrangement with their creditors or by means of the arrangement and reconstruction provisions under section 166 of the Ordinance. However, there is nothing in section 166 to prevent a creditor presenting a petition to wind up the company, an event which could have the effect of ending the formulation of any proposal to creditors. The Law Reform Commission (LRC) considers that the major deficiency with section 166 is the lack of a moratorium that can bind creditors while an arrangement plan is being formulated.

3. The LRC therefore recommended in 1996 in its Report on "Corporate Rescue and Insolvent Trading" that Hong Kong should introduce a corporate rescue procedure. Under the proposal, there would be a statutory stay of proceedings which would protect a company from actions against it by its creditors during the period of the moratorium thus providing a breathing spell to a viable business in financial difficulty to restructure and survive as a going concern. The recommendation was made after public consultation on the subject by the LRC Sub-Committee on Insolvency in 1995.

Main features of corporate rescue/provisional supervision

4. The LRC sought to formulate a corporate rescue procedure that would be cheap, quick, simple and effective with minimal involvement of the court to save time and costs. The two main features of a statutory corporate rescue are -

(a) the introduction of a *moratorium* (stay of proceedings) which will protect the debtor company from creditor action for an initial period of 30 days and thereafter an extension of up to six months from the commencement of the moratorium subject to the court's approval; and

(b) the taking over of the control of the company during the moratorium by an independent professional third party, the *provisional supervisor*, who will formulate a voluntary arrangement proposal for creditors within the specified time-frame.

------- A summary of the LRC's recommendations is at Annex B.

"Debtor in possession" concept not recommended

5. The corporate rescue model proposed by the LRC is based largely on the Australian and Canadian provisions[1]. In putting forward its proposals, the LRC has been mindful that corporate rescue procedure should not be used by unscrupulous directors as a vehicle to avoid their obligations. The concept of "debtor in possession"[2] used in Chapter 11 of the US Bankruptcy Code was not accepted by the LRC as they did not believe that creditors in Hong Kong would accept it. The LRC believed that allowing the independent provisional supervisor to take effective control of the company during the corporate rescue period would be the best safeguard against possible abuses.

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[1] The LRC had researched into the systems for corporate rescue in various jurisdictions including the United Kingdom, Australia, Canada, the United States and Singapore.

[2] A Chapter 11 case allows a debtor who intends to reorganize his business to continue to operate his business as a "debtor-in-possession" under the protection of the court. The debtor will seek to down-size or close non-viable operations, effect changes in management, etc. and to negotiate with creditors to repay part of their debts and creates a business entity as a going concern.

The moratorium

6. Under the LRC proposal, the moratorium would commence at the same time as the corporate rescue procedure (the provisional supervision), that is, 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 is 30 days, after which, if the provisional supervisor finds that he needs more time to formulate a proposal for creditors, he may apply to the court to extend the moratorium for any period up to a maximum of six months from the commencement of the moratorium. Thereafter, only the creditors may resolve to extend the moratorium further, but it would not be necessary to seek the court's approval for such extensions.

7. During the moratorium, no application for the winding up of the company by the court may commence or be continued; no receiver of the assets of the company may be appointed; no steps may be taken to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession; no proceedings or other process may be commenced or continued against the company or its property, and no right of forfeiture or of entry or re-entry may be exercised.

Exemptions from the application of the moratorium

8. The LRC has recommended that eligible financial contracts, for example currency or interest rate swap agreement, or an agreement to buy, sell securities, should be exempted from the moratorium. These dealings occur in certain closed markets, such as the central clearing and settlement system of the Stock Exchange. To impose a moratorium on such contracts could involve unraveling innumerable other contracts which would cause chaos in the market concerned.

9. There are also situations where the moratorium should not be applied. First, to enable a company to continue with its normal business during the provisional supervision, it would need to maintain the necessary credit facilities with its business partners. The LRC therefore proposed that debts and liabilities incurred by the company after the initiation of the corporate rescue procedure should not be affected by the moratorium. Secondly, any resumptions by the Government pursuant to a Government lease or otherwise should be exempted from the moratorium.

The Provisional Supervisor

10. Once appointed, the provisional supervisor would effectively take charge of the company. To inspire confidence, he must be independent, with integrity and possess the necessary expertise. The LRC recommended that provisional supervisors should only be selected from a panel of practitioners operated by the Official Receiver and comprising solicitors and professional accountants. The Official Receiver may also approve suitably qualified independent persons as provisional supervisors.

11. The provisional supervisor would be empowered to manage and control the company and would be acting as the agent of the company in the exercise of his powers. He has the right to retain or dismiss directors of the company. He may exclude any class or classes of creditors from the moratorium and would be personally liable for any contract entered into by him in the performance of his functions. He would be indemnified out of the assets of the company. The functions of the provisional supervisor are summarized in paragraph 25 of Annex B.

12. The LRC anticipates that in practice, before a provisional supervision is initiated, a company must consult with its major secured creditors to get them onside. For a company to act otherwise will be ill-advised, as major secured creditors will have the power under the legislation to opt out of a moratorium within three working days after receipt of notification by the provisional supervisor, and the provisional supervision will cease immediately. As soon as practicable after the provisional supervisor has ascertained the financial position of the company, he should decide whether the purposes of a voluntary arrangement are capable of being achieved. When the provisional supervisor has formulated a plan, he will call a meeting of creditors to consider it. He will also report to creditors if he is unable to formulate a plan, or decides that none of the purposes of the voluntary arrangement can be achieved. The meeting should resolve to terminate provisional supervision and to wind up the company as a creditors' voluntary winding up.

Effects of a voluntary arrangement

13. When a voluntary arrangement plan has been approved by creditors[3], the provisional supervision will cease and the terms of the voluntary arrangement would take effect. The voluntary arrangement will be binding on every creditor, on the company and its members. Accordingly, no creditor bound by the arrangement may commence or continue any winding up proceedings or receivership action or any other legal process against the company.

Insolvent trading

14. In relation to the introduction of a corporate rescue procedure and in order to encourage directors and senior management to act on insolvency earlier rather than later, the LRC has recommended that directors and senior management be made personally liable for the debts of a company which traded while insolvent. The introduction of the "insolvent trading" provisions would encourage directors and senior management to face the fact that a company was slipping into insolvency at an early date and cause them to address the situation.

Our position

15. We see merits in introducing a cheap, quick and effective statutory corporate rescue procedure in Hong Kong. Businesses in difficulties would be given an opportunity to attempt to turn around. Employment that would otherwise disappear might be preserved, at least to some extent.

16. We henceforth propose to adopt the LRC model for corporate rescue in the Bill, <u>except</u> in the following main areas where we propose to deviate from the LRC recommendations as outlined below.

(a) outstanding wages and other entitlements owed to employees who are laid off by a company in provisional supervision

17. The LRC has recommended that in case outstanding wages and

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[3] For any resolution to pass at a meeting of creditors, approving a proposal or modified 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.

other entitlement are owed to employees who are laid off by a company undergoing corporate rescue, those employees should be allowed to make an application for ex-gratia payment from the Protection of Wages on Insolvency Fund (the PWIF). This in effect would widen the present scope of the PWIF, which, as it stands, is only triggered by the presentation of a winding up petition against the company.

18. We conducted a three-month consultation on this subject in December 1998. A copy of the relevant consultation paper and the report on the consultation exercise are at Annexes C and D respectively.

19. While supporting corporate rescue in principle, none of the employers/employees groups supported the proposed change in use of PWIF. They feared that there could be abuse by unscrupulous employers who might first lay off employees and then evade their statutory responsibility of paying arrears of wages/entitlements by passing the burden to the PWIF. Both the Labour Advisory Board and the PWIF Board expressed strong reservation on this particular LRC proposal.

20. Taking into account the strong views expressed, we propose that the company undergoing corporate rescue must be responsible for clearing all arrears of wages, severance pay and other statutory entitlements of its employees as if it is a going concern. This is desirable because employees' rights will then be fully protected; and that it would help remove opportunities for possible abuse of PWIF in the course of corporate rescue.

(b) companies to whom the rescue procedure would not apply

21. The LRC has recommended that the corporate rescue procedure should apply to local as well as oversea companies formed/registered under the Companies Ordinance. The only exception is the authorized institutions (AIs)[4] which are regulated by the Hong Kong Monetary Authority under the Banking Ordinance (Cap. 155). The LRC held the view that the corporate rescue provisions should apply to insurance companies and the securities and futures industry.

22. We have no difficulty with the exemption of AIs. However, we have reservation in allowing provisional supervision to be applied to

[4] Under the Banking Ordinance, authorized institutions include banks, restricted licensed banks and deposit taking companies.

insurance companies and registered entities in the securities and future industry. Similar to AIs though varying in degree, these entities are already regulated by law which empowers the regulator to assume control of the regulated entity or oblige the entity to act in a certain manner in case the entity has financial difficulty.

23. We therefore propose that provisional supervision should not apply to insurers who are regulated under the Insurance Companies Ordinance; registered dealers and other persons regulated under the Securities Ordinance (Cap. 333) (SO) and the Commodities Trading Ordinance (Cap. 250) (CTO), and licensed leveraged foreign exchange traders under the Leveraged Foreign Exchange Trading Ordinance (Cap. 451) (LFETO).

(c) who may initiate provisional supervision

24. The LRC was of the view that whoever has the power to initiate provisional supervision should do so from a position of knowledge of the company's financial position and prospects. It therefore recommended that the company or its directors, liquidators and receivers[5] should be able to initiate the procedure in appropriate circumstances.

25. In respect of receivers, the LRC only included them into the above list with hesitation. It is arguable that there could be a conflict of interest for a receiver turned provisional supervisor in terms of whose interests he served – the creditor who appointed him as receiver, the company, or all the creditors of the company.

26. On careful consideration, we are convinced that the possibility of a conflict of interest does exist if a receiver is allowed to turn into a provisional supervisor, because the receiver would not be able to change the direction of a receivership without the agreement of the creditor who appointed him. In order to avoid any possible conflict of interests, we recommend that receivers should not be allowed to initiate provisional supervision.

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[5] Receivers are appointed primarily to realize the company's assets comprised in the debenture holders' security, to distribute the proceeds of sale to the debenture holders in satisfaction of their claims, and to return any surplus or unrealized assets to the company which may then continue with its business or, if it is insolvent, go into liquidation. [Vanessa Stott, Hong Kong Company Law Eighth Edition]

Regulatory powers of the Securities and Futures Commission over listed companies

27. The LRC Report is silent on the regulatory powers of the Securities and Futures Commission (SFC) over listed companies. When a moratorium is in force, no party may initiate legal proceedings against the company which is under provisional supervision. The SFC, being a non-government body, is bound by the moratorium under the bill.

28. However, there may be instances where, under the overriding principle of investor protection, the SFC may need to exercise its regulatory powers, for example, to conduct investigations or inspect documents of a company undergoing provisional supervision. Proceedings by the Insider Dealing Tribunal (IDT) should also be allowed to commence or continue in respect of a company undergoing rescue. Hence, we are proposing in the Bill to exempt from the moratorium IDT proceedings and the SFC in the exercise of its regulatory powers under the relevant provisions of the Securities and Futures Commission Ordinance (Cap. 24) and LFETO.

Recommendations of the Standing Committee on Company Law Reform to amend the Ordinance

29. The Bill has also incorporated various recommendations of the Standing Committee on Company Law Reform (SCCLR) to amend the Ordinance. Some of those recommendations have been set out in the Legislative Council brief on SCCLR Fifteenth Annual Report - 1998/99 dated 30 September 1999 (at Annex E). They are summarized below.

30. Section 194 of the Ordinance provides that the OR automatically becomes the provisional liquidator on the making of a winding up order by the Court. In order to reduce the caseload of his office arising from the increase in the number of compulsory winding up cases, the SCCLR has agreed to a proposal by the OR to amend section 194 to provide the OR with the authority to appoint directly a suitably qualified and experienced person to be the provisional liquidator of the company on the making of the winding up order, and thereafter the liquidator.

31. At present, the filing requirements in respect of the first annual return by private companies under sections 107 and 109 of the Ordinance

are cumbersome. To simplify such requirements, the SCCLR proposed that private companies would be required to file their first returns within 42 days after their first anniversaries of incorporation, regardless of when the companies held their first Annual General Meetings.

32. Section 116B of the Ordinance provides that a resolution in writing signed by all members is deemed to be a resolution having been passed at a duly convened general meeting. The SCCLR examined the general application of this provision with a view to removing existing conflicts with other provisions in the Ordinance and to facilitate the operations of smaller companies by reducing the number of formal meetings. Accordingly, the SCCLR has proposed to amend section 116B along the provisions of the UK Companies Act 1985 to enable a company to dispense with the holding of general meetings provided that unanimous written resolutions are used; the resolutions are signed by or on behalf of all members of the company; and a copy of the proposed written resolution is sent to the auditors of the company.

33. Section 228A of the Ordinance provides for the speedy appointment of a provisional liquidator by majority resolution of the directors of a company so that the company can be placed in voluntary winding up in an emergency situation. However, there have been continuous complaints that this procedure has been abused and creditors' interests have been adversely affected. As there are other means provided elsewhere in the Ordinance to initiate voluntary winding up and to appoint a provisional liquidator speedily, the SCCLR has proposed that the section be repealed and we agree accordingly.

34. The SCCLR has also proposed to lower the threshold for the requisition for convening an extraordinary meeting from the present requirement of members holding not less than one-tenth of the paid-up share capital to one-twentieth. This will facilitate the requisition of a meeting of the company by minority shareholders in particular and, as such, is in the interest of better corporate governance.

35. The Bill also provides the opportunity to rectify certain technical omissions and to streamline and update a number of provisions in the Ordinance.

THE BILL

36. Clauses 3, 7, 8, 9(b), 10, 11, 15 and 46 to 49 make technical amendments to a number of sections of the Ordinance to simplify and reduce the filing obligations for both local and oversea companies and their directors.

37. Clause 9(a) amends section 107 to simplify the filing requirement of the first annual return of a private company having a share capital. Under the simplified procedure, the date of filing of that return is no longer linked to the date of the company's first annual general meeting.

38. Clause 13 amends section 113 to lower the threshold for the voting rights/amount of paid up capital held by members permitted to requisition an extraordinary general meeting from one-tenth to one-twentieth.

39. Clause 14 implements the proposal on company resolution by unanimous written consent by repealing section 116B and replacing it by the new sections 116B, 116BA and 116BB. Exceptions to the use of unanimous written resolutions are the removal of directors or auditors from office before the expiry of their term of office because both have the right to make representations at a general meeting of a company. One further exception relates to the repurchase of shares from a shareholder by the company. The shareholder concerned is not allowed to vote on resolutions that are related to that repurchase.

40. Clause 24 adds the new Part IVB to give effect to the proposals on corporate rescue procedure. The new section 168V specifies the categories of companies to which corporate rescue shall/shall not apply. The new sections 168W and 168X empowers the Official Receiver to appoint a panel of professional accountants and solicitors eligible for appointment as provisional supervisors. The directors or a liquidator of the company may appoint a provisional supervisor under the new section 168Y.

41. The filing and notification requirements in respect of the notice of appointment of the provisional supervisor are set out in the new sections 168ZA to 168ZC. The Notice has to include a 'consent to act' form duly signed by the provisional supervisor. The form will be prescribed by the OR who will require, amongst other matters, the level of remuneration of the provisional supervisor to be displayed prominently in the consent form

for creditors to be so informed in the first instance. In addition, the Notice will require the company to confirm that it has set aside sufficient money to settle the statutory liabilities owed to its employees and former employees under the Employment Ordinance (Cap. 57) before the company goes into provisional supervision.

42. The effects of moratorium and the exemptions to it are set out in the new section 168ZD. The new section 168ZE provides for extensions to the moratorium subject to the sanction of the court. The duties and powers of the provisional supervisor are set out in the new sections 168ZF and 168ZG, and the new Eighteenth Schedule. Powers of directors are to be suspended under the new section 168ZI and the provisional supervisor will act as an agent of the company.

43. The new sections 168ZJ and 168ZK specify the liability of the provisional supervisor vis-à-vis contracts of goods and services and contracts of employment entered into before and after the rescue. Where the provisional supervisor accepts a pre-existing contract of employment, or enters into a new contract of employment, the wages and salaries thereby payable have priority over the provisional supervisor's remuneration. The provisional supervisor is indemnified out of the property of the company for all debts for which he is liable under the new section 168ZL.

44. Under the new section 168ZM, the provisional supervisor is remunerated in accordance with a scale of fees approved by the Official Receiver. The court, on the application of the provisional supervisor, may vary the scale. Creditors may also object if they consider the fees to be excessive.

45. The provisional supervisor is required to prepare a statement of affairs of the company as soon as practicable under the new section 168ZN. The procedures for the removal and resignation of the provisional supervisor are set out in the new section 168ZO.

46. The creation of 'super' priority debt is in the new section 168ZP. Borrowings made by the company in provisional supervision will receive priority over all existing debts, with the exception of fixed charges. This is necessary because in all likelihood, a company under rescue would need to raise capital to fund its operations during the provisional supervision period.

47. The new section 168ZQ sets out the procedures for major creditors of the company to decide whether or not the provisional supervisor may proceed to prepare the proposal. If a major creditor refuses, then the moratorium ceases and the provisional supervisor vacates his office. If the major creditors agree to the drawing up of a proposal but the proposal is eventually rejected by the creditors, the company may either be wound up as a creditors' voluntary winding-up, or if it was previously under court winding-up procedures, the stayed procedures would be re-activated.

48. The requirements and procedures for the creditors' meetings to consider the proposal by the provisional supervisor are in the new sections 168ZR to 168ZT. Where the proposal is accepted by the creditors, a voluntary arrangement will follow and the procedures for such an arrangement are in the new sections 168ZU to 168ZY.

49. Clause 44 adds new sections 295A to 295G to implement the proposals on insolvent trading. Section 295B empowers the liquidator of a company to make an application to the court to seek declaration that a "responsible person", i.e. a director or a member of senior management, is liable for insolvent trading. Grounds on which the court may declare a responsible person liable for insolvent trading are set out in the new section 295C. The new section 295E provides that where the court makes a declaration of insolvent trading in respect of a responsible person or former responsible person, it may order that person to pay compensation to the company.

50. Clauses 30 amends section 194 to give the Official Receiver, where he is the provisional liquidator of a company, the authority to appoint a person as provisional liquidator in his place in summary winding-up cases where the Official Receiver is of the opinion that the assets of the company is unlikely to exceed $200,000. This will facilitate the Official Receiver to contract out summary compulsory winding-up cases.

51. Clause 23 amends section 168R to enable the Registrar of Companies to maintain a complete set of company director disqualification orders. The present provisions do not provide for filing of disqualification orders handed down by the IDT under the Securities (Insider Dealing) Ordinance (SIDO) to the R of C. This clause seeks to rectify the situation.

52. Clause 20 introduces a new section 168IA to remove the

deficiency in section 222 by allowing the Official Receiver to conduct public examination in court of a director of a company which has been wound up by the court when there is a prima facie case for the application for a disqualification order under Part IVA of the Ordinance.

53. Clause 42 seeks to rectify an anomaly in section 264A by making it clear that interest on the taxed costs of a petition for winding up is payable in accordance with that section as with interest on other proved debts, and not with the same priority as the taxed costs of the petition itself.

54. Clause 46 amends section 333 so that, apart from individuals or partnerships of accountants or solicitors, incorporated firms of accountants or solicitors can also accept process on behalf of oversea companies. This is to rectify a technical omission in relation to the amendments made to the Ordinance and the Professional Accountants Ordinance in 1995 to provide for incorporation of professional accountant firms.

55. Clause 50 amends section 345 so that firms of certified public accountants or public accountants having over 20 partners can admit non-practising-certificate holders as partners. This consequential amendment was omitted when the Professional Accountants Ordinance (Amendment) Ordinance 1994 was introduced to relax the requirement on partners being holders of practising certificates.

56. The other clauses seek to make technical, textual or consequential amendments to the Ordinance.

LEGISLATIVE TIMETABLE

57. The legislative timetable is as follows -

Publication in the Gazette	7 January 2000
First Reading and Commencement of Second Reading debate	19 January 2000
Resumption of Second Reading debate, committee stage and Third Reading	to be notified

HUMAN RIGHTS IMPLICATIONS

58. The Department of Justice advises that the Bill is consistent with the human rights provisions in the Basic Law.

BASIC LAW IMPLICATIONS

59. The Department of Justice advises that the Bill is consistent with those provisions of the Basic Law carrying no human rights dimensions.

BINDING EFFECT OF THE LEGISLATION

60. Individuals and organizations, including the HKSAR Government will be subject to the application of the moratorium when they are acting in the capacity as creditors of the company.

FINANCIAL AND STAFFING IMPLICATIONS

61. With the introduction of the new statutory corporate rescue procedure, the ORO will need to maintain a panel of provisional supervisors which may generate additional workload to the department. Any additional resources required will be absorbed by the ORO through internal re-deployment and from within the global allocation of the Secretary for Financial Services. Other proposals in the Bill have no financial or staffing implications for Government.

ECONOMIC IMPLICATIONS

62. The corporate rescue procedure would help financially ailing but potentially viable business as to survive as a going concern, in whole or in part. It would be beneficial to the company's shareholders and creditors who might in due course get a better return from the success of the rescue than from the outcome of a winding-up. The procedure will be particularly helpful in reducing the stress to the economy when a greater number of companies with viable business for the longer term face more

immediate, but relatively short term, financial difficulties in a cyclical economic downturn.

63. The improvements made to the various provisions of the Ordinance under the Bill will make our company law more business-friendly and thus enhance Hong Kong's position as a commercial and financial centre in the region.

PUBLIC CONSULTATION

64. The LRC Sub-Committee on Insolvency carried out a public consultation on the concept of corporate rescue in 1995. A consultation exercise on certain proposals of the LRC was conducted by the Financial Services Bureau in 1998 with 26 major business/professional and employer/employee bodies. The consultation exercise and the results were reported on two occasions to the Financial Affairs Panel of the Legislative Council in February and June 1999 respectively. The SCCLR expressed support for the introduction of a statutory corporate rescue at one of its meetings in 1996. Subsequently, at the meeting on 14 December 1999, the SCCLR examined the draft provisions on corporate rescue and insolvent trading. Concern was expressed over a possible conflict of interest that might arise if a provisional supervisor is allowed to become the liquidator of the company should creditors resolve to wind up that company. However, we believe that it makes commercial sense to leave the choice of liquidator to the creditors themselves if they consider that the provisional supervisor is the most appropriate person to become the liquidator of the company in the circumstances. A provisional supervisor turned liquidator would save time and money as he would by then have grasped a fair amount of knowledge of the affairs of the company to quickly proceed with the winding up.

65. All the other recommendations outlined in paragraphs 30 to 34 above have been discussed and supported by the SCCLR.

PUBLICITY

66. A press release will be issued on 6 January 2000 and a spokesman will be available to handle media enquiries.

ENQUIRIES

67. For enquiries, please call Mr L W TING, Assistant Secretary for Financial Services (Companies) at 2528 9077.

Financial Services Bureau
Ref : FSB C2/1/12C(99)IX