THE LAW SOCIETY OF HONG KONG

COMMENTS BY THE COMPANY AND FINANCE LAW COMMITTEE ("COMPANY COMMITTEE") AND THE INSOLVENCY LAW COMMITTEE ("INSOLVENCY COMMITTEE") ON THE COMPANIES (AMENDMENT) BILL 2000

1. Provisional Supervision and Voluntary Arrangements

The purpose of the Bill is not stated in its text. However, broadly speaking, the main thrust of the Bill is to create a statutory regime for corporate rescue, comparable to those which have been adopted (with limited success) in other common law jurisdictions.

In summary, the Bill provides for a statutory freeze on individual creditor enforcement and a power to bind dissenting creditors into a rescue proposal. The Bill would give the directors and shareholders of a company the power to initiate the new proceedings without any supervision from the court. A "provisional supervisor" is immediately appointed to take control of the company and a statutory moratorium on creditors' claims (including security enforcement) is imposed.

In general, the Company Committee is supportive of the proposal to introduce an appropriate rescue procedure into Hong Kong law, so as to bring Hong Kong into line with other jurisdictions. However, the Company Committee does not consider that the Bill, in its current form and without further amendment, would introduce an appropriate, fair and workable procedure into Hong Kong law. There are also serious doubts that its introduction would enable more financially troubled companies to survive. The reasons are set out below:

(a) Absence of court involvement

A striking feature of the Bill, in comparison to its cousins overseas, is that it provides for very little court involvement or other independent supervision as regards (a) entry into the procedure, (b) conduct of the procedure and development of rescue proposals, and (c) voting and binding minorities contrary to their wishes and previous legal rights.

It is fundamental to the protection of the innocent that new laws which, if implemented by certain members of the public (i.e. directors or shareholders), would seriously affect the legal rights of others, should contain appropriate safeguards to prevent abuse and to ensure competing interests are fairly balanced. Such protections would usually include the involvement of, or rights of appeal to, the court or some other appropriate authority in various circumstances.

(b) The "Wild West"

The Companies Committee is concerned that, in practice, reputable and experienced insolvency practitioners may be unwilling to accept an appointment as provisional supervisor in many cases. This is because the Bill imposes various personal liabilities automatically upon the provisional supervisor, which would be payable by him personally, regardless of whether there exists available funds in the company. These liabilities include the wages of those employees "kept on" by him during the rescue process and certain trade liabilities incurred whilst keeping the company alive and its goodwill intact. If experienced and reputable persons are not willing to take over the running of a financially troubled company, the role would likely be assumed, on a risk/reward basis, by less reputable characters or, alternatively, fall upon the public sector.

(c) **Usefulness**

The Bill would not have any extra-territorial effect, so as to afford protection to companies with assets in other jurisdictions (e.g. Mainland China) or to groups of companies where various companies in the group are incorporated or located overseas. Whilst this would no doubt reduce the possibility of Hong Kong's laws conflicting with those of other jurisdictions, particularly Mainland China, it may nevertheless render the rescue procedure of limited assistance to most companies or groups of companies currently carrying on business in Hong Kong.

As business globalises, the Companies Committee wonders whether it is "too late in the day" for the legislature to be seeking to fill an age-old legislative gap by the introduction of a rescue procedure which may only be of assistance to small, "old economy" Hong Kong corporates.

(d) **Fixed charge security**

It is curious that the (unquantifiable) costs and expenses of the provisional supervisor would rank ahead of fixed charge security, whereas the costs and expenses of liquidation would normally rank behind fixed charge security. This anomaly may be difficult for lawyers to explain to their clients, since there appears no logical justification for it. No doubt the financial community will make separate representations on this point and as to the difficulties they may face in the future when lending to Hong Kong companies on a so-called secured basis.

Similarly, the invalidation of fixed charge security created within 12 months of the commencement of the rescue procedure, except to the extent of "new monies" provided, can be contrasted with the position in liquidation where only floating charges can be invalidated on such ground. Again, there appears no logical justification for the distinction. Perhaps secured creditors may even be prompted to seek an early liquidation of the company, so as to preempt an invalidation of their security by the directors or shareholders seeking to use the new rescue procedure.

(e) **Drafting**

Finally, the Bill is not particularly user-friendly and its drafting contains numerous inconsistencies, ambiguities, and inadequacies. These factors could exacerbate the costs of utilising the statutory rescue procedure and may well provoke litigation. If

possible, these unnecessary features should be minimised by further work on, and clarity in, the drafting of the Bill, with the assistance of experienced and specialised external advisers if necessary.

2. **Insolvent Trading**

Generally, the Society welcomes the introduction of legislation rendering directors and senior management accountable in respect of their management decisions to a company's liquidator and/or the court in the event of its insolvent liquidation.

In circumstances of potential insolvency, a well-advised director would, of course, keep detailed records, minutes etc. so as to ensure that he can justify his decisions and actions at a later date if required. However, it must be recognised that during the weeks or months prior to an insolvent liquidation, there will usually be many pressures on the time and emotions of directors and senior management. It should also be recognised that not all directors or senior managers will have access to legal advice on how best to protect themselves. There may be cases where directors have insufficient time or forget to keep evidence of their personal actions, whilst nevertheless acting responsibly and with creditors' interests in mind. An unscrupulous liquidator, or a liquidator supported by an unscrupulous creditor, could bring proceedings against such individual and succeed.

Accordingly, the Company Committee's view is that the liquidator should be obliged to prove more than merely "insolvent trading" (i.e. that the company traded on having developed a cash-flow problem), but actually that (a) there has in fact been a loss suffered by creditors as a result of the insolvent trading, and (b) the individual in question was in a position to influence the direction of the company in a manner that may have avoided such loss.

3. **Specific Sections**

(a) **Section 168ZK Liability for certain contracts of employment**

This section renders the provisional supervisor of a company personally liable for "wages, salaries and other emoluments" under contracts of employment. In the case of existing contracts, this applies if they are accepted by the provisional supervisor within 14 days of the "relevant date" (i.e. date of commencing the provisional supervision process).

If the existing contract is not accepted or is terminated within the 14-day period, it is deemed terminated by the company on expiration of that period. "Wages salaries and other emoluments" are then deemed to be liabilities of the company that were incurred on or after the relevant date. They are charged to be paid out of the property of the company as a priority payment.

One of the arguments originally raised against this provision was that many companies that seek the benefit of the moratorium that applies in provisional supervision are likely to be at the point where they are, in effect, insolvent and have little in the way of funds or assets. The liability for these amounts therefore means that in order to use the provisional supervision/voluntary arrangement procedure, it would be necessary for a funding creditor to advance funds to pay these amounts. This was considered likely to limit the use of the new procedure.

The experience of members of the Insolvency Committee is that creditors such as banks are not generally inclined to advance further funds in these circumstances. If they do, they require detailed information of the amounts that might ultimately be involved. They also nearly always wish to assess the future prospects of the company as a prerequisite to any funding decision. 14 days is a very short period in which to gather information and make these assessments. Troubled companies tend to have poor records and it often takes weeks or even months to assess their true position.

For example, experience shows that most companies in difficulty tend to retain their staff while in difficulty and keep salaries up to date in order to avoid adverse publicity. But items such as the payment of MPF (which is presumably an "emolument") where there is unlikely to be any obvious evidence of default, are very likely to have fallen into arrears. Often the amounts involved are not readily ascertainable but they could be very substantial. Unpaid VAT or national insurance in UK liquidations are examples of this.

The effect of this provision is that unless the amount necessary and the prospects can be ascertained within 14 days there will be even fewer creditors willing to offer funding.

Provisional supervisors are therefore unlikely to be able to make a decision on whether to retain employees within 14 days of appointment and are likely to take the view that the only prudent decision is to terminate if there is any doubt on this subject.

The members of the Insolvency Committee consider that the general use of provisional supervision as a way of preserving viable businesses will be limited as a result of this provision. Neither is it likely to preserve employment.

(b) **Section 295**

Under Section 295C the Court has the power to declare a "responsible person" to be liable for insolvent trading.

Section 295C defines "responsible persons" as "directors and shadow directors as in the equivalent UK legislation. However, it also refers to "a manager of a company who is involved to a substantial or material degree in directing the company's business or affairs".

There is an exemption for managers in Section 295C(2)(a)(i) and (ii) if they can satisfy the Court that before the relevant debts were incurred, they issued a notice

in the form specified in Part 2 of the Nineteenth Schedule to the Board of Directors of a company stating that the company was engaged in insolvent trading and attaching a copy of Section 295B or alternatively that they took every step to minimise the potential losses to the company's creditors.

This provision was originally discussed in the Report of the Committee at page 108 paragraph 19.32. It was thought that senior management may know the financial position of the company as well as directors and therefore there should be an obligation to warn directors as soon as possible.

The members of the Insolvency Law Committee agree with these general sentiments however they also consider that the addition of managers who are "involved to a substantial or material degree in directing the company's business or affairs" was imprecise. Potentially, it exposes a range of persons with varying management responsibilities within a company to a possible liability for insolvent trading when they may not necessarily have a full or complete picture of the company's true financial situation.

If managers are to be included as a category of person potentially liable, it should be limited to the most senior management levels where they have direct reporting responsibilities to the board. Those managers' responsibilities should also include knowing the company's overall financial position as part of their day to day management duties.

It was also considered that in the case of typical smaller Hong Kong companies an obligation of this type is unlikely to be particularly effective. Even if it was most managers of small companies were aware of their obligation and what it involves most would find it difficult to serve notices on their directors. It would be likely to create difficult personal situations and managers would be inclined to desist for that reason.

While the Insolvency Committee agrees with the general objectives of this provision they consider that it may not be workable in Hong Kong at this time other than in the case of larger companies and senior managers at the highest level where they report directly to the directors and have responsibilities to know the company's overall financial position.

(c) **Section 228A**

This is the section dealing with the commencement of creditors voluntary liquidation by way of a resolution by directors which is subsequently confirmed by a meeting of creditors. It has been suggested that this is subject to abuse and this section has been repealed in the Companies Bill 2000.

Abuse has always been offered as a reason to repeal this provision however, relatively few specific examples have been cited.

The members of the Insolvency Law Committee take the view that all liquidation procedures can potentially be the subject of abuse. In the case of Section 228A there is always the safeguard of a full creditors meeting where there is an

opportunity to have a voice on the question of appointment of liquidators. Also, in view of the new insolvent trading provisions, the onus is on directors to act responsibly and cease trading quickly in the event that creditors' interests are at risk. The relative ease and speed with which a company can be placed into liquidation using the 228A procedure is a reason to consider its retention.

(d) **Section 295E (1)(b)**

This involves the power to restrict compensation to creditors who knew the company was trading while insolvent. If applied objectively this provision could affect banks who agree to advance funds in good faith to assist companies to carry out a workout where the financial position of the company cannot be established when the decision to advance funds is made. There should be scope for the Court to consider the reason for advancing funds in exercising this power.

4. General

By way of more general comments:

(a) The Secretary of Financial Services is invested with the power to amend schedules and provisions to a much greater extent than is normally the case in primary legislation. Whilst it is common for this to occur in relation to subsidiary legislation it is undesirable that this power should exist in relation to substantive provisions.

(b) If and when the Bill is passed it is strongly recommend that any regulations or rules be introduced simultaneously.

5. **Miscellaneous**

(a) The Committee supports the introduction of clauses 3, 7, 8, 9(b), 10(a) and (b)(ii), 11, 15, 46, 47, 48 and 49 which make technical amendments to section 21, 57B, 64A, 107, 109, 110, 157D, 333, 333A and 336 respectively to reduce the documents required to be filed by local and overseas companies and their directors.

(b) The Committee supports the introduction of clause 9(a) which amends section 107 to simplify the annual return filing requirements.

(c) The Committee questions whether there is presently doubt that the existing section 116B may not enable a company to pass a resolution without holding a meeting if all the shareholders agree and thus questions whether Clause 14 and the consequential amendments contained in clauses 4, 5, 6, 12 and 51 of Bill are necessary. Although clause 12 which amends section 111 and specifies the process by which a company may hold a paper AGM is helpful.

(d) The Committee supports the introduction of clause 15 as it clarifies the resignation process for a director or secretary.

(e) The Committee does not object to clause 20 of the Bill but questions its usefulness in practice.

(f) The Committee does not object to clause 39 which repeals section 228A and seeks clarification on why this amendment is considered appropriate.

The Law Society of Hong Kong

Company & Financial Law Committee

Insolvency Law Committee

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