30 July 2001

Clerk to Bills Committee on Companies (Corporate Rescue) Bill
Legislative Council Secretariat
3rd Floor, Citibank Tower
3 Garden Road
Central
Hong Kong

Dear Sir/Madam,

COMPANIES (CORPORATE RESCUE) BILL

We are responding to your invitation for comments on the above bill.

We are against the proposals set out in the bill. We expressed our reasons for our opposition to the provisional supervision concept in our original submission, dated 31st August 1995 (http://www.hkdf.org/papers/950831insolven.htm), a copy of which is attached.

In summary, while we can see that the bill would benefit insolvency practitioners, we believe that it has little other merit. The negative effects of the proposal – in undermining the rights of creditors and obstructing the "creative destruction" of weak firms - outweigh the benefits, if any, that the proposal might bring to the stakeholders of the individual firms concerned. The analysis of "Economic Implications" in the related Legislative Council Brief is too narrow. The proposed provisional supervision process appears complex and would be difficult to render transparent to the parties involved. It would therefore provide opportunity for the unscrupulous to manipulate or take advantage of the situation. The assertion that the provisional liquidator "must be independent, acting with integrity" (page 3 of the brief) is otherworldly. At best, the insolvency process requires horse trading, application of pressure, even bullying, to get things done. A franker acknowledgement of the human realities of the process would do the brief more credit.

For further details we refer you to earlier submission.

Yours sincerely,

Alan LUNG Ka-lun
Chairman

Mr Jeremy Glen
The Secretary
The Insolvency Sub-committee
The Law Reform Commission
20/F., Harcourt House,
39 Gloucester Road,
Wanchai,
Hong Kong.

31st August, 1995

Dear Sir,

CONSULTATION PAPER ON CORPORATE RESCUE AND INSOLVENT TRADING

We are writing in response to your invitation to comment on the above consultation paper.

Generally we find the paper technically well-researched with helpful reference the experience of developed overseas jurisdictions.

However, we have serious reservations about the proposals themselves, both the concept of provisional supervision and the directors' responsibility for insolvency. We find that inadequate consideration has been given to the broader implications of either proposal.

Our more detailed comments are given below.

1. NEGATIVE ECONOMIC EFFECTS OF PROVISIONAL SUPERVISION

From the point of view of the public interest, the critical question is whether it is appropriate for there to be Government-mandated intervention in corporate failure at all. As the paper acknowledges in section 1.16, it may be said that,

> "... a crude, though effective, reorganization process already operates in the demise of businesses or industries and their replacement by new businesses or industries."

In a risk-taking capitalistic economy, there will always be businesses ventures that fail. The resources of failing businesses - their assets and staff - will be redeveloped through the action of market forces to more efficient competitors. These ventures will in turn expand to fill the gap left by the failing business.

Thus the process of business failure is vital to the ongoing health and development of the economy. Attempts to artificially preserve failing or less efficient businesses, while no doubt beneficial to the shareholders and other stakeholders of that specific business, will generally be detrimental to the economy as whole.

The intervention process preserves in existence a business that by definition is less well-managed than its competitors. This alone may be damaging to the economy. However the corporate rescue process has other negative effects.

A procedure like provisional supervision is only possible if there is a moratorium on creditors winding the company up. However, such moratorium cannot be effected without depriving creditors of their basic right to pursue their debt. If creditors know that they may be so deprived of their rights they will tend to be more cautious about extending credit. Alternatively they may alter their behaviour so as to exploit any loopholes that the insolvency legislation leaves, as acknowledged in sections 13.11-13 of the paper. And while some creditors may be inhibited by such insolvency legislation, others may be emboldened by it to take risks that without such legislation would be imprudent. In all these cases the outcome will be less than optimal from the point of view of the efficiency of the economy as a whole.

We are not persuaded by the fact that many developed countries such as Australia and the UK have sophisticated corporate rescue procedures. In addition to such procedures these countries have a vast range of tax reliefs, direct grants, training subsidies, etc. aimed at preserving businesses that would otherwise fail or stimulating those that would otherwise not materialise at all. Yet the economies of these countries have traditionally suffered from sluggishness, poor adaptability and high unemployment. It is at least arguable that the poor adaptability is partly due to this very plethora of corporate support measures, including procedures for corporate rescue.

We are therefore not convinced that special procedures for corporate rescue, such as the provisional supervision proposed in the paper, are needed at all. At the very least the economic case for such procedures must be made much more strongly than it is in the paper.

We would, however, be strongly supportive of measures to make the liquidation process itself more efficient. The paper quite rightly points to the inefficiency of corporate liquidation, a process that may take years and where the assets of the liquidated company may be partly or wholly the consumed by legal costs and professional fees. We believe that priority should be given to reviewing the liquidation process rather than to developing corporate rescue procedures which, as the paper acknowledges, will be used in a minority of cases at best and may additionally have unexpected and negative economic implications.

2. OTHER COMMENTS ON PROVISIONAL SUPERVISION

Our strong reservations on the concept of provisional supervision are expressed in section 1 above. If such procedure is adopted notwithstanding, we have the following specific comments.

1. We agree with the paper's rejection (1.11) of the concept of debtor in possession along the
lines of the US Chapter 11. In the Hong Kong environment there would be too great a potential for abuse.

2. We feel that there are conflicts in the role of provisional supervisor, as proposed, that will need stronger checks and balances than are included in the paper. We feel that it is insufficiently clear what objective the provisional supervisor is working for and to whom he is accountable. It appears that he is supposed to be trying to save the company in the public interest, but we doubt that in the real

world individuals, whether directors or insolvency practitioners, are quite so altruistic. Further guidance on these points may be needed.

The provisional supervisor is to be appointed by the directors or members of the failing company and, although he may get rid of the directors, he is generally expected to work with them. There is a clear possibility of collusion between the provisional supervisor and the directors - who, as the paper acknowledges, may be minded to "... use provisional supervision as a vehicle for dissipating assets and avoiding statutory liabilities." (8.4)

There is also the risk of collusion between the provisional supervisor and certain creditors, since the provisional supervisor has the power to enter into arrangements with individual creditors, and also to incur fresh debts which are to be paid off in priority to the existing debts.

Finally, in view of the discretionary powers the provisional supervisor is to be given, there is the possibility of the provisional supervisor abusing his position for his own benefit alone.

In the Hong Kong environment we believe the dangers of abuse of the kind suggested above are very great. If the provisional supervision concept is proceeded with, we would expect at the very least a code of conduct for such work and some form of enforcement by a relevant professional body. We would also expect statutory remedies for parties who were able to demonstrate abuse and statutory penalties for the provisional supervisor in breach of his duties.

3. INSOLVENT TRADING

We believe that the proposals to introduce presumptions imputing specific responsibility for insolvency to the directors, and even senior management, are unduly harsh and are unreasonable. We strongly recommend that they be reconsidered.

In many cases insolvency will arise as a result of genuine misadventure. The failure of a substantial customer to pay a debt, the refusal of a bank to renew finance, even a simple loss of a major order to a competitor - all these events can bring insolvency despite the best efforts of the directors. Moreover, these events can occur suddenly. It is unreasonable to propose that the simple fact of insolvency should lead to a presumption of a civil wrong by the directors. Further, not all directors may be expert in financial matters, and even those who are may be taken unawares by rapidly unfolding events. While there are no doubt cases where directors wilfully negligently continue trading in an insolvent company, it is unreasonable to institute a presumption of a civil wrong in all cases. If there is abuse in a particular case, there are already established civil and criminal remedies. Any fresh remedies proposed should first be justified in terms of the purported inadequacy of these remedies, but we do not find such justification in the paper.

We are greatly concerned that the effect of these proposals may be deter conscientious and principled persons from faking up directorships at all, especially non-executive directorships, which would be to the detriment of the economic community.

We believe that to hold the directors responsible for the insolvency of a company to some extent pierces the veil of incorporation. As such the proposal may have wide implications and we recommend that fuller study is made before any implementation.

We wonder if specific consideration has been given to whether the presumptions of continuing solvency and of insolvent trading where proper books of account have not been kept (19.3) raise any difficulties in relation to the Bill of Rights Ordinance.

We also wonder whether it is necessary to introduce a new definition of "director" in the insolvency legislation, or whether such legislation could simply refer to the existing definition in the Companies Ordinance, as quoted in 19.15.

It appears to us that the proposals to hold senior management of the company responsible for the company's insolvency could be unduly harsh. Senior management would normally be acting under the instruction of the directors. If there is concealment or abuse established civil and criminal remedies are already available.

We hope that the above comments are helpful.

We also look forward to the Commission's review of personal insolvency, which we feel is an area where there is sometimes unnecessary hardship to the individual without commensurate benefit to the community as a whole.

Yours sincerely,

Dr Patrick Shiu
Chairman