

The Hon. Margaret Ng,
Chairperson,
Bills Committee for the Companies (Corporate Rescue) Bill 2001

24 September 2001

Dear Margaret,

Re: Bills Committee for the Companies (Corporate Rescue) Bill 2001

I understand that you are in the Chair for the above Bill. I would be grateful if you would accept this submission.

My observations on the Bill can be divided into two parts: first, the treatment of workers' wages; and, secondly, other matters. With reference to "other matters", I attach some comments on a number of technical aspects of the Bill (see attached file, Corporate Rescue Bill – other matters.doc).

Workers Wages:

Turning to the crucial issue of the treatment of workers' wages and other entitlements, I note that the legislation is still proposing that a company will be required to pay off in full – or set up the relevant trust account to pay off in full – "all debts and liabilities" owing to its present and former employees (Second Schedule, para 3(d)). I am sure you are already quite familiar with the range of objections that have been voiced about this approach. In essence, the objections are twofold: (a) that payments must be made "up front" (that is, before a company can even initiate provisional supervision); and (b) that the amounts involved are without any limit or cap (namely, "all" debts and liabilities). I need not mention that a number of insolvency practitioners have labeled this approach as fatally flawed.

Workers Wages: Option A

I, together with my colleague Charles Booth, have tried to formulate an approach to workers' wages that will not be a major obstacle to the success of the provisional supervision regime, nor involve any costs on the part of the Protection of Wages on Insolvency Fund (PWIF), and yet still do justice to the workers. Our suggestions have been set out in a recent paper, which is attached to this email (see Workers' Wages; proposal by Smart & Booth.doc). We have sought to formulate an approach which avoids the two objections ((a) and (b)) mentioned above. In this email, I call this **Option A**. Option A is also based upon the idea that it simply makes no sense (and is unfair to some workers) that if a company goes into provisional supervision its workers must be paid everything they are owed, but if the company is liquidated the workers will only be paid up to their statutory entitlements from the PWIF.

In summary, in relation to Option A, we have suggested in the paper that the legislation should be re-drafted so as to contain three elements:

1. a new concept, which we would call “employees’ protected debts”, should be introduced; this would be defined in order precisely to track the various amounts which may presently be claimed from the PWIF upon a compulsory liquidation;
2. every proposal by a provisional supervisor for a voluntary arrangement (to be put within the initial 30-day moratorium to the creditors’ meeting) must contain a provision to the effect that any outstanding employees’ protected debts will be immediately paid by the company in cash upon the voluntary arrangement coming into effect; and
3. the legislation should expressly state that the court may not extend the moratorium beyond the initial 30-day period, unless the provisional supervisor undertakes that, within 14 days of the court granting the extension, all the employees’ protected debts will be paid off in cash by the company.

Workers Wages: Option B

Even if Option A does not meet with the approval of the Bills Committee, because the workers will not be entitled to be paid all their debts – as is the case under the present Bill – I would respectfully suggest that our proposal could be modified. I call this **Option B**. (Option B is *not* discussed in the attached paper.)

Instead of having “employees’ protected debts”, defined by reference to the amounts available from the PWIF in a liquidation, Option B proposes that the amount the workers will receive will be **all debts and liabilities** owing under the Employment Ordinance (i.e. adopting the wording in the present Bill). Under Option B:

1. a concept, called “relevant employee debts”, would be introduced;
2. this would be defined as meaning “all debts and liabilities” arising under the Employment Ordinance (i.e. following the basic approach now taken in the Bill);
3. every proposal by a provisional supervisor for a voluntary arrangement (to be put within the initial 30-day moratorium to the creditors’ meeting) must contain a provision to the effect that all relevant employee debts will be immediately paid by the company in cash upon the voluntary arrangement coming into effect; and
4. the legislation should expressly state that the court may not extend the moratorium beyond the initial 30-day period, unless the provisional supervisor undertakes that, within 14 days of the court granting the extension, all relevant employee debts will be paid off in cash by the company.

The advantage of Option B over the present Bill is that a company would **not** have to find the necessary moneys “up front” to pay off its employees before going into provisional supervision. Yet, the workers would still have to be paid “all debts and liabilities” if the provisional supervision were to go beyond the initial 30-day moratorium period.

Option B would at least allow companies a chance to get the protection of a moratorium (for a short period of time) whilst they try to get support from creditors for a rescue plan. The Bill, as presently drafted, will inevitably prevent many companies that could have gone into provisional supervision – and might have been rescued – from even having that chance. The detriment to workers, whose jobs will not be saved, is all too apparent.

In other words, I have put forward **Option B** as something of a compromise. In fact, it is my view that Option B is actually **more** favourable to workers than the present Bill – as under the present Bill very few companies will ever have the chance of going into provisional supervision, it means nothing that the workers will be paid all their debts and entitlements. The all debts and liabilities approach only has any real meaning if companies have some chance of getting respite from their creditors and obtaining temporary relief from the storm of their financial difficulties. The very foundation of provisional supervision must be that a company can get the benefit of the moratorium without great expense or delay. Option B at least achieves this and fully protects workers.

I apologize for the length of my comments, but would be happy to respond to any questions that you might have.

Best regards,
Sincerely yours,

Philip Smart

Philip Smart
Associate Professor
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Brief Notes on the Companies (Corporate Rescue) Bill 2001

Insolvent Trading

- 1 The intended s 295A(2) defines when a company 'goes into liquidation', it would appear that reference to s 228A should be added otherwise there might seem to be a gap (now that s 228A has not been repealed, as was at one time anticipated).
- 2 Section 295C(1) deals with when a responsible person may be declared liable for insolvent trading. There is reference in sub-para (c) to 'and the responsible person failed to take any steps to prevent the insolvent trading'. As drafted this applies to all responsible persons and is, in effect, an additional requirement for liability. But is this what is intended? Namely, that *any* step to prevent insolvent trading means the responsible person is off the hook? That would be odd considering the more strict nature of the 'defence' for senior management in s 295C(2). The provision in Australia (Corporations Law, s 588H(5)) is:
'It is a defence if it is proved that the person took *all reasonable steps* to prevent the company from incurring the debt.'
My opinion is that a new sub-para (d) should be added to s 295C (removing the relevant phrase presently in sub-para (c)), as follows:
'(d) The responsible person failed to take all reasonable steps to prevent the insolvent trading.'
- 3 Section 295E deals with compensation and expressly allows it to be used to meeting the costs of the action. But there is nothing in the Bill about the costs if the action *fails*. In the light of the very restrictive approach in recent UK cases to what is an expense of the liquidation (e.g. *Grey v IRC*), I would suggest that it be spelt out in the Bill that the costs of a failed action will be regarded as an expense of the liquidation. It is plain that liquidators will be very reluctant ever to use the legislation if there is the prospect that, should the action fail, the liquidator will be personally liable for costs and will not be able to recoup from the estate of the company.

Provisional Supervision

- 4 Workers' wages. I have already had my say (and more) on the merits of the proposals, but there is also a technical issue. Schedule 2 makes reference to wages 'owing by virtue of' the Employment Ordinance (EO). Of course, we know what this means; but I cannot see a provision in the EO which makes wages a statutory entitlement. The EO deals with when, where and how wages may (or may not) be paid, but I think a claim for wages arises by virtue of the *contract* between the parties (not the EO). A minor point, I admit. Perhaps, an employment law expert would know better than I.

5 Avoidance powers/investigations. My feeling is that Schedule 4, part 1, para 2 was added in response to criticisms of the earlier Bill. It currently states that the provisional supervisor is to:

‘2. Investigate and assess the business, property, affairs and financial circumstances of the company (including any possible claim that may be taken by the liquidator of the company under any of sections 264B, 266 to 266B, 275, 276 or 295A to 295G of the Companies Ordinance (Cap. 32) if the company is being wound up as a creditors' voluntary winding up on the relevant date).’

But, as drafted, this provision seems less than clear as to what is intended. It actually states that possible claims under the designated sections are only relevant if the company was in CVL prior to the commencement of the provisional supervision. It makes, I suggest, no sense that this should be so I would suggest that it would be better if it stated:

‘Investigate and assess the business, property, affairs and financial circumstances of the company (including any possible claim that *might have been* taken by a liquidator of the company under any of sections 264B, 266 to 266B, 275, 276 or 295A to 295G of the Companies Ordinance (Cap. 32) *had the company been put into* creditors' voluntary winding up on the relevant date).’

6 Utilities. In the UK, and under the BO, special provision is made to prevent ‘commercial blackmail’ by the utility companies in a rescue situation (see s 30E of the Bankruptcy Ordinance). I wondered if a positive decision *not* to include such a provision had been made in relation to provisional supervision?

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Provisional Supervision and Workers' Wages: An Alternative Proposal

Philip Smart* and Charles D Booth**

In May 2001 the Companies (Corporate Rescue) Bill was gazetted. The Bill makes provision for a statutory corporate rescue mechanism, to be known as provisional supervision. The most controversial aspect of the Bill is the treatment of workers' wages. The Bill essentially requires that before a company may even enter into provisional supervision, it must have paid off in full all debts (and other entitlements) owing to its workers. The Bill does not, however, explain how a financially distressed company is supposed to find the cash to meet the statutory requirement. This requirement may also be criticized because it is at odds with the treatment of workers' wages in other insolvent procedures, thus leading to unfairness. This article proposes an alternative approach; one which, it is suggested, is in the interests of both financially troubled companies and their workers.

Introduction

Even before the onset of the Asian financial crisis in mid-1997, it had long been recognised that a statutory corporate rescue mechanism was needed in Hong Kong.¹ Hence, the legislative implementation of the initiatives suggested by the Law Reform Commission of Hong Kong (the "LRC") in October 1996 in its *Report on Corporate Rescue and Insolvent Trading*² has been eagerly awaited by insolvency practitioners in the territory. In January 2000 the Companies (Amendment) Bill 2000 (the "2000 Bill")³ was gazetted and full details of the proposed provisional supervision regime became

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This paper was originally presented to a Workshop on Provisional Supervision and Workers' Wages held under the auspices of the Asian Institute of International Financial Law, University of Hong Kong, on Thursday, 26th October 2000. The authors gratefully acknowledge the contribution of the various participants at the Workshop to this article.

¹ For background to the topic of corporate rescue in Hong Kong, see The Law Reform Commission of Hong Kong Sub-Committee on Insolvency, *Consultation Paper on Corporate Rescue and Insolvent Trading* (Hong Kong, Government Printer, 1995) and Charles D. Booth [2001] JBL 126.

² The Law Reform Commission of Hong Kong, *Report on Corporate Rescue and Insolvent Trading* (Hong Kong, Government Printer, 1996) available at <<http://www.info.gov.hk/hkreform/reports/index.htm>>.

³ The Companies (Amendment) Bill 2000 was gazetted on 7 January 2000, see Hong Kong Government Gazette, Legal Supplement No 3, C5. The 2000 Bill and other relevant materials are available on the Legislative Council's website, at <<http://www.legco.gov.hk/yr99-00/english/bc/bc06/general/ebc06.htm>>. The 2000 Bill would have added some 33 sections, the proposed ss 168U to 168ZZA, to the Companies Ordinance (Cap 32). For details of the current legislative proposals, gazetted in May 2001, see n 9 below.

available. Although there were many interesting (and some controversial)⁴ aspects in the provisional supervision regime as put forward in the 2000 Bill, broader public debate concentrated almost exclusively on the treatment of workers' wages and other entitlements.⁵ For the 2000 Bill adopted what, as far as these commentators are aware, was a unique position on the issue of workers' wages; it being proposed that, before a company could even go into provisional supervision, it must either have: (a) actually paid off all sums owing (pursuant to the Employment Ordinance) to its employees and former employees; or (b) established a trust account at a bank containing sufficient funds to extinguish all such debts.⁶ The major difficulty with requiring an already financially distressed company to settle all such debts before it might seek refuge in provisional supervision is, of course, that the company may likely lack the necessary cash to make such payments. The late Joseph Heller⁷ might, perhaps, have found the situation familiar. It is no exaggeration to state that sections of the insolvency practitioner community in Hong Kong regarded the 2000 Bill as "fatally flawed"⁸ in this regard.

Although the proposed provisional supervision regime was dropped from the legislative agenda in May 2000, it has recently re-appeared as the Companies (Corporate Rescue) Bill 2001 (the "Corporate Rescue Bill")⁹ and, as expected,¹⁰ the position in

⁴ See, generally, P.St.J. Smart and Charles D. Booth [2001] Corporate Finance & Insolvency Law Review (forthcoming). For further details on the proposed provisional supervision regime, see http://www.insolvency.com.hk/new%20provisional_supervision.htm.

⁵ See, for example, Enoch Yiu, "New law protects laid off workers", South China Morning Post (Business News), 4 June 1999, p 2; Enoch Yiu, "Warning note sounded on corporate rescue plan", South China Morning Post (Business News), 5 June 1999, p 3; and Jan Blaauw, "HK firms need more protection", South China Morning Post (Markets), 29 May 2000, p 12. Note also Joe Bannister, "UK and Hong Kong Propose New Rules for Company Rescues" IFL Rev 51, 54 (June 2000) and Jane Moir, "'Unworkable' rescue bill bounces back into Legco", South China Morning Post (Business News), 6 February 2001, p 1.

⁶ See proposed s 168ZA(c)(iv); essentially the same requirements are now to be found in para 3(d) of the Second Schedule to the Companies (Corporate Rescue) Bill 2001, n 9 below.

⁷ Author of the celebrated novel, *Catch-22* (1961).

⁸ See http://www.insolvency.com.hk/new%20provisional_supervision.htm for criticism and comments by Simon Powell and Stephen Briscoe, two well-known insolvency practitioners.

⁹ The Companies (Corporate Rescue) Bill 2001 was gazetted on 18 May 2001, see Hong Kong Government Gazette, Legal Supplement No 3, C615. The Corporate Rescue Bill will also introduce provisions on insolvent trading into the law of Hong Kong, see para 8 of the Eighth Schedule.

¹⁰ See Jane Moir, "'Unworkable' rescue bill bounces back into Legco" (n 5 above). On 5 February 2001 the Financial Services Bureau submitted a paper (CB(1) 522/00-01(03)) to the Financial Affairs Panel of the Legislative Council dealing with this topic; paragraph 2 states: "We propose to maintain the original

relation to workers' wages has not been fundamentally altered.¹¹ The purpose of this article, after briefly analysing the defects of the treatment of workers' wages under what is now the Corporate Rescue Bill, is to put forward an alternative proposal.

Workers' Wages and Corporate Insolvency

Where a company is insolvent and a winding up petition has been presented, employees who have not received their wages (and other entitlements) can apply to the Protection of Wages on Insolvency Fund (the "PWIF") for ex gratia payments up to specified amounts.¹² The LRC's *Report on Corporate Rescue and Insolvent Trading*¹³ proposed that, ideally, the Protection of Wages on Insolvency Ordinance should be amended so that the onset of provisional supervision should trigger the operation of the PWIF.¹⁴ (It may be noted that, in the United Kingdom, employees may claim their entitlements from the equivalent statutory fund whether their employer has gone into liquidation or has become subject to a statutory rescue procedure.)¹⁵ However, concerns were expressed in Hong Kong that, if the LRC's recommendation were to be adopted, unscrupulous employers might lay off their employees – without paying them their entitlements – and then put the company into provisional supervision; thereby, so it was argued, passing the

proposal of requiring a company to settle all outstanding arrears that it owed to its employees before starting a statutory corporate rescue operation as set out in the Companies (Amendment) Bill 2000." The paper is available at http://legco.gov.hk/yr00-01/english/panels/fa/papers/fa_c.htm .

¹¹ See para 3(d) of the Second Schedule to the Corporate Rescue Bill, set out below.

¹² Protection of Wages on Insolvency Ordinance (Cap 380), s 16(1)(b). Although s 16(1)(b) specifically refers to the presentation of a winding-up petition, rather than the making of a winding-up order, the practice of the Protection of Wages on Insolvency Fund Board appears to be not to exercise its discretion to make ex gratia payments where the company is not in fact going to be wound up. A number of cases have arisen recently in Hong Kong where a petition has been presented, but the company has obtained a stay of proceedings whilst negotiating with creditors in order to enter into a scheme of arrangement. In such circumstances the Board has refused to make ex gratia payments on the basis that it is not a "corporate bailout" fund. See Antoine So, "Sacked workers denied fund aid", South China Morning Post, 4 January 2000, p 4; Jane Moir "UDL rescue scheme gets go-ahead", South China Morning Post (Business News), 19 April 2000, p 4; and *Re UDL Holdings Ltd (No 3)* [2000] 3 HKC 405, appeal dismissed [2001] 1 HKLRD 156. In *Re BG Lighting Co Ltd*, CWU 3 of 2000, 22 May 2000 (unreported, Court of First Instance) Le Pichon J observed: "I would respectfully suggest that the correctness of the 'policy' of refusing to make ex gratia payments to former employees in the absence of a winding-up order needs to be revisited. The Board's discretion is triggered, not by a winding-up order but by the presentation of a winding-up petition: see s 16(1)(b) of the Protection of Wages on Insolvency Ordinance. To refuse to exercise the discretion without a winding-up order appears to be not only improper but also contrary to legislative intent. The Board should take note that its 'policy' has far-reaching ramifications: it may not ultimately be in the interest of the ex-employee creditors and in the longer term may prove to be damaging to the public interest and the prosperity of Hong Kong."

¹³ See n 2 above.

¹⁴ *Ibid*, para 5.42.

¹⁵ See the Employment Rights Act 1996, s 184.

burden of unpaid wages, severance and other payments onto the PWIF.¹⁶ It is also significant that in the financial year 1997-98, during which the impact of the Asian financial crisis began to be felt in Hong Kong, the PWIF recorded its first ever deficit (some \$25 million), as the number of claims by employees increased by more than 60% over the previous year.¹⁷ The Government's initial estimate (given in the Legislative Council on 3 February 1999) was that there would be deficits of \$160 million in 1998-99, of \$114 million in 1999-2000 and of \$108 million in 2000-01.¹⁸ (In fact, the *Annual Report of the Protection of Wages on Insolvency Fund Board 1998-99* reveals that the deficit for 1998-99 was higher, some \$185.3 million.)¹⁹ It was even suggested that the solvency of the PWIF might be threatened if a significant number of provisional supervisions were to be commenced after the enactment of the new procedures.²⁰ A consultation exercise²¹ was conducted by the Financial Services Bureau in 1999, as a result of which the relevant provision in the 2000 Bill was drafted so that the appointment of a provisional supervisor could not come into effect until the appointor had filed an affidavit stating that the company:²²

- (A) has a trust account -
 - (I) with an authorized institution within the meaning of the Banking Ordinance (Cap 155);
 - (II) the exclusive purpose of which is to provide money to pay all debts and liabilities owing, by virtue of the Employment Ordinance (Cap 57), by the company to its employees and former employees before the relevant date; and
 - (III) containing sufficient money to pay all those debts and liabilities; or
- (B) has paid all debts and liabilities, or has no debts and liabilities, owing, by virtue of the Employment Ordinance (Cap 57), to its employees and former employees before the relevant date.

The Corporate Rescue Bill has adopted a like approach (although it in fact increases the sums in respect of which a company is required to make provision before going into

¹⁶ Stewart Oldfield, "Supervision plan stirs collapse fear", South China Morning Post (Business News), 29 December 1998, p 1. See also Karen Cooper, "Authorities fear exploitation of workers aid fund", South China Morning Post (Business News), 22 December 1998, p 3.

¹⁷ *Annual Report of the Protection of Wages on Insolvency Fund Board 1997-98*, 5.

¹⁸ *Hong Kong Hansard*, 3 February 1999 (Secretary for Education and Manpower, in response to a question from Mr Eric Li) (see <<http://www.legco.gov.hk/yr98-99/english/counmtg/hansard/990203fe.htm>>).

¹⁹ *Annual Report of the Protection of Wages on Insolvency Fund Board 1998-99*, 4.

²⁰ These commentators would suggest, however, that the financial impact of extending the PWIF to provisional supervision would be relatively minor, see text accompanying nn 35-38 below.

²¹ *Consultation Paper on Corporate Rescue and the Protection of Wages on Insolvency Fund (Treatment of Employees in "Provisional Supervision")*, Feb 1999, available at the Financial Services Bureau's website, at <<http://www.info.gov.hk/fsb/consult/index.htm>>.

²² Proposed s. 168ZA(c)(iv); see now Corporate Rescue Bill, Second Schedule, para 3(d), set out below.

provisional supervision).²³ The Corporate Rescue Bill requires that before a provisional supervisor can be appointed the appointor²⁴ must have filed an affidavit²⁵ stating that the company:²⁶

(i) has a trust account -

(A) with an authorized institution within the meaning of the Banking Ordinance (Cap. 155);

(B) the exclusive purpose of which is to provide money to pay all debts and liabilities owing, by virtue of the Employment Ordinance (Cap. 57), by the company to its former employees before the relevant date (including those employees whose contracts of employment will be terminated on or after the relevant date) and to pay all wages owing by virtue of that Ordinance to its existing employees up to the relevant date; and

(C) containing sufficient money to pay all those debts and liabilities; or

(ii) has paid all debts and liabilities, or has no debts and liabilities, owing, by virtue of the Employment Ordinance (Cap. 57), to its former employees before the relevant date (including those employees whose contracts of employment will be terminated on or after the relevant date) and owes no wages by virtue of that Ordinance to its existing employees up to the relevant date.

Criticism of the Treatment of Workers' Wages under the Corporate Rescue Bill

As has been noted above, the major difficulty flowing from the treatment of outstanding workers' wages under the proposed legislation is that a company that is contemplating going into provisional supervision – and therefore likely to be in serious financial difficulty – is required to find enough money to pay off all liabilities to its employees and former employees or to fund the relevant trust account for such purpose. Clearly, this requirement might, in certain instances, actually prevent a company from going into provision supervision; thereby precipitating the winding up of the company. But this is only one of several problems with the legislation.²⁷

²³ This is because para 3(d), see text accompanying n 26 below, gives an extended definition to “former employees”, so as to include employees who, although not laid off as of the relevant date, will be laid off subsequently. This presumably covers employees whom the directors know will later be laid off under the provisional supervision.

²⁴ The appointment of the provisional supervisor will normally be a matter for the board, see further Corporate Rescue Bill, s 6.

²⁵ See Corporate Rescue Bill, s 8 for details.

²⁶ Corporate Rescue Bill, Second Schedule, para 3(d).

²⁷ There is, these commentators would suggest, one particular drafting difficulty with the provision. Para 3 (d) is concerned with (a) all debts and liabilities owing “by virtue of the Employment Ordinance” to former employees and (b) all wages “owing by virtue of that Ordinance” to existing employees. The difficulty is that, on the face of it, a claim for wages (by former or existing employees) does not arise “by virtue of” the Employment Ordinance. The Ordinance does have various provisions about how, when and

Firstly, where a company does not have the cash to pay off its liabilities to its employees in full, it might seek funding from a bank; but it is likely that a bank would be unwilling to lend such sums to any company desirous of going into provisional supervision, as the bank would know that the money would go straight to the employees and would not directly assist in re-financing the company. Second, there is the (highly undesirable) likelihood that a company contemplating provisional supervision might stop making any effort to pay its trade creditors and hoard as much cash as possible in order to accumulate a sufficient lump sum to pay off its workers. To this extent it might even be said that the legislation encourages a company deliberately to create what, in other circumstances, might be condemned as a preference.²⁸ (Although it would appear that, were the company subsequently to go into liquidation, the liquidator could not recover the moneys paid to the employees as preferences, since the motive of the directors²⁹ would not have been to improve the position of the employees but to enable the company to meet the statutory requirements to enter into provisional supervision.) Third, the legislation leads to inconsistency: for where an insolvent company is wound up the workers can only look to the PWIF for payment up to specified maximum amounts; but if that very same company were to go into provisional supervision, the Corporate Rescue Bill would require “all debts and liabilities” arising by virtue³⁰ of the Employment Ordinance (without any ceiling, or cap, as there is under the PWIF scheme) owed to the employees to be discharged. (See, further, Table A, below.) Whether a company goes into liquidation or opts for provisional supervision might seem to its employees to be largely a matter of chance, and certainly not within their control. Thus, for example, within a group of insolvent companies there might be one or two companies that go into provisional supervision, whilst the other companies are wound up: some employees³¹ would be paid off at once and in full, whilst other employees would have to wait for their claims to be settled by the PWIF and then only up to specified maximum amounts. Finally, although the reference to “all debts and liabilities” in the Corporate Rescue Bill might seem at first sight to benefit workers, these commentators suspect that in practice the opposite might often be the case; as the “all debts and liabilities” provision would make a rescue more difficult to initiate, the consequence may well be that a company that might otherwise have had a chance of being saved will instead end up in liquidation – and employment that might have been preserved will have been lost.

As has already been noted, the treatment of workers’ wages under the 2000 Bill attracted considerable adverse comment from the legal and accounting professions. Moreover, in the Legislative Council the Bills Committee in June 2000, having identified

where wages should be paid – wages must be paid in cash (or by cheque etc), as soon as possible after falling due and may not be paid in a shop, a place of amusement or any place where alcohol is served etc – but a claim for wages arises by virtue of the *employment contract* between the parties, rather than by virtue of the Ordinance. It is submitted that some clarification is required in the legislation.

²⁸ See s 266B of the Companies Ordinance.

²⁹ Note *Re MC Bacon Ltd* [1990] BCC 79.

³⁰ See above n 27.

³¹ Namely, those whose employer has gone into provisional supervision (rather than liquidation).

the treatment of workers' wages as an issue of major concern, pointed out that the 2000 Bill did not allow for any flexibility,³² so that, even if a company's workers consented, it would not be permitted for a company to pay the workers less than 100% of their entitlements whilst at the same time providing them with some other consideration (such as stock options). The Bills Committee recommended the "early resubmission" of the corporate rescue proposals to the (then) incoming Legislative Council and, in the meantime, suggested that: "the Administration should meet with various professional bodies ... so that the proposals can be fine-tuned".³³ In early 2001 it was indicated to legislators that re-submission was imminent and, in particular, that the Administration – after consultation with the PWIF Board and the Labour Advisory Board – was not minded fundamentally to amend its treatment of outstanding workers' wages and other entitlements.³⁴ The Corporate Rescue Bill has, as noted above, adhered to the approach taken in the 2000 Bill.

An Alternative Proposal

These commentators would respectfully agree with the LRC that the most rational approach to workers' wages would be to extend the PWIF to provisional supervision. As far as unscrupulous employers are concerned, the Labour Department already has the ability to prosecute employers who take advantage of their employees' labour when they are aware that there is no reasonable prospect of the employees being paid their wages as they become due.³⁵ With respect to the solvency (or potential insolvency) of the PWIF, it has been Hong Kong's general economic situation – not the prospect of the introduction of provisional supervision – that has already made this a pressing issue. Further, there are three main reasons why extending the PWIF to provisional supervision would likely have little net effect on the solvency of the PWIF. First, the number of companies that may in the future go into provisional supervision will inevitably be only a fraction of those forced into insolvent liquidation. (The costs associated with provisional supervision will

³² *Report of the Bills Committee on the Companies (Amendment) Bill 2000 to House Committee Meeting on 9 June 2000* (Legislative Council Paper, CB(1) 1779/99-00), p.4, which is available at http://legco.gov.hk/yr99-00/english/bc/bc06/reports/bc06_rpt.htm.

³³ *Ibid*, p.5

³⁴ See n 10 above. It would appear that whilst the Administration was contemplating some alteration to the general position taken in the 2000 Bill, the PWIF Board and the Labour Advisory Board were resistant to change (*ibid*).

³⁵ Section 31 of the Employment Ordinance (breach of which is by s 63A made a criminal offence) provides:

“(1) No person shall enter into, renew or continue a contract of employment as an employer unless he believes upon reasonable grounds that he will be able to pay all wages due under the contract of employment as they become due.

(2) An employer shall, if he ceases to believe upon reasonable grounds that he will be able to pay all the wages due by him under a contract of employment as they become due, forthwith take all necessary steps to terminate the contract in accordance with its terms.”

clearly put the procedure out of reach of the bulk of Hong Kong companies.)³⁶ Secondly, the majority of companies that go into provisional supervision will be doing so in an attempt *to avoid insolvent liquidation*; in relation to these companies the PWIF would have to pay the workers in any event. The only additional financial burden on the PWIF would be in respect of those (surely very few) companies that would choose to go into provisional supervision even though they were not facing the imminent prospect of insolvent liquidation.³⁷ Thirdly, even where payments to workers were made by the PWIF, it would be able to recoup at least a percentage of those payments by way of subrogation in the provisional supervision. On the other hand, the financial benefit to the PWIF would be that provisional supervision should save employment that would otherwise have been lost; if, for example, fifty jobs with a company can be saved through provisional supervision (jobs that would have been lost in a liquidation), there will be fifty fewer workers seeking severance payments from the PWIF.³⁸

Nevertheless, in light of the refusal to extend the ambit of the PWIF, these commentators would put forward an alternative suggestion. Our starting point is that the treatment of outstanding workers' wages, assuming no involvement on the part of the PWIF, should be based upon the following criteria:

- the treatment of workers' wages and other entitlements should neither prevent nor be a serious impediment to a company going into provisional supervision;
- employees should not be "left out in the cold"; more particularly, employees should in substance be no worse off in a provisional supervision than they would be were their employer to go into compulsory liquidation;
- any new approach must be equitable (to both the workers and the company's other creditors); and
- any proposal must not place an excessive administrative burden on the provisional supervisor.

In the light of these criteria our proposal is that the legislation should be re-drafted so as to contain three elements:

4. a new concept, which we would call "employees' protected debts", should be introduced; this would be defined in order precisely to track the various amounts which may presently be claimed from the PWIF upon a compulsory liquidation;
5. every proposal by a provisional supervisor for a voluntary arrangement (to be put within the initial 30-day moratorium to the creditors' meeting) must contain a

³⁶ Small companies and even small-medium sized companies are very unlikely to be able to afford the professional fees that will inevitably be connected with provisional supervision; such companies always account for the majority of liquidations.

³⁷ In fact, the LRC was concerned that Hong Kong directors would be unwilling to put their companies into provisional supervision as to do so would mean handing over control (albeit only temporarily) to an outsider; see, generally, Charles D. Booth (1998) 14 IL & P 248, 252.

³⁸ Whilst there is some force in the argument that the PWIF should not be used to "subsidize" corporate rescues, it should not be overlooked that the funding of the PWIF comes not from Government's general revenue but directly from business itself (by means of a levy on the issue of business registration certificates).

provision to the effect that any outstanding employees' protected debts³⁹ will be immediately satisfied in cash upon the voluntary arrangement coming into effect;⁴⁰ and

6. the legislation should expressly state that the court may not extend the moratorium beyond the initial 30-day period, unless the provisional supervisor undertakes that, within 14 days of the court granting the extension, all the employees' protected debts⁴¹ will be paid off.

A rough outline of the manner in which our suggestions might work in practice is as follows. First, provisional supervision could be initiated, and accordingly the moratorium come into effect (thereby giving the company an all-important breathing space), without any payments being made "up front" to the workers. Secondly, if the provisional supervision collapses within the initial 30-day moratorium period,⁴² the company will go into liquidation and the workers will have their normal rights and remedies (including, when the statutory requirements have been made out, applying to the PWIF for ex gratia payments). Third, if a plan for a voluntary arrangement is approved by the creditors within the 30-day period, the terms of the arrangement must provide for the immediate payment in full (in priority to everything else) of the employees' protected debts. Finally, where the provisional supervisor believes a voluntary arrangement can be achieved but he requires an extension of the moratorium, the court will only grant an extension upon the condition that⁴³ the employees' protected debts are paid in full within 14 days of the court's order. If the provisional supervisor cannot give an undertaking to make these payments, no extension will be granted and the company will be put into liquidation.

Although in a case where provisional supervision continues beyond the initial 30-day moratorium period, the workers might have to wait some six or seven weeks from the date the provisional supervisor was appointed before receiving their unpaid wages and other entitlements (up to the levels laid down by the PWIF), such a delay is not significantly different from the delay that would normally accompany a claim to the PWIF in a compulsory winding up.⁴⁴ Moreover, the possible benefit to workers in such circumstances would be two-fold: not only might some or all of their jobs be saved where a voluntary arrangement enables the company's business to continue in whole or in part,

³⁹ As of the date of the creditors' meeting.

⁴⁰ The only exception would be where an employee has waived this right in writing, thereby meeting the flexibility point raised in the Bills Committee, see text accompanying n 32 above.

⁴¹ As of the date of the court order.

⁴² It is highly likely that a significant proportion of all provisional supervisions would fail at such an early stage.

⁴³ Unless the workers have agreed otherwise in writing, see above n 40, and the court is satisfied that their interests have been adequately protected.

⁴⁴ The performance pledge of the Labour Department is to make payments from the PWIF within ten weeks of the date of the filing of a winding-up petition: see *Annual Report of the Protection of Wages on Insolvency Fund Board 1998-99*, p.5.

but also any wages or other entitlements still owing to an employee (over and above the protected amounts) would be an unsecured debt under the voluntary arrangement (and, in all probability, some dividend could be anticipated in due course).

It might be useful to consider how these proposals would operate if a company like, let us say, United Dockyards Ltd were to go into provisional supervision.⁴⁵ The company would appoint a provisional supervisor who, after ascertaining that a plan for voluntary arrangement was a realistic possibility, would apply to the court for an extension to the initial 30-day moratorium. The provisional supervisor would be aware that the court would require prompt payment of protected debts owed to the employees as a condition for the granting of an extension of the moratorium; the provisional supervisor would, accordingly, take appropriate steps to ascertain the amounts owed to the employees as protected debts and would be ready to make payment shortly after the court order. The employees would not have to face the sort of lengthy delays that currently occur, as in the United Dockyards case, where a company promotes a scheme of arrangement. (A scheme of arrangement is, at present, the only formal (statutory) mechanism available under which a proposal for a corporate rescue or re-structuring can be pursued.)⁴⁶ Under our proposal, within only a few weeks of the appointment of the provisional supervisor, the employees would receive substantial payments. In addition, the amount of the employees' protected debts would be far more generous than the sums presently recoverable by employees as (preferential) creditors in a scheme of arrangement.⁴⁷

Conclusion

The pressing need for the introduction of a statutory corporate rescue mechanism into Hong Kong insolvency law is undeniable. It is perhaps unfortunate that the treatment under the 2000 Bill of outstanding workers' wages and other entitlements attracted so much attention and thereby apparently contributed to a delay in the implementation of the proposed provisional supervision regime. Even though the Corporate Rescue Bill has retained the all debts and liabilities approach, these commentators would maintain that a statutory rescue regime that is in certain regards seriously flawed is better than nothing at all. Yet, sooner or later, the all debts and liabilities in advance approach will likely have to be re-thought. As experience in other jurisdictions has shown, insolvency laws, and in particular rescue mechanisms, are not immutable and are constantly being refined.⁴⁸ Whilst these commentators would not suggest that their proposal is ideal (or anywhere near ideal), its major advantage over the approach in the Corporate Rescue Bill is that it would in no way inhibit a company in financial difficulty from obtaining the all-

⁴⁵ See *Re UDL Holdings Ltd (No. 3)* above n 12.

⁴⁶ See Companies Ordinance, s 166.

⁴⁷ A claim for (up to a maximum of) \$8,000 in respect of wages is a preferential debt in a winding up and a scheme of arrangement would normally provide for payment of that preferential amount in full.

⁴⁸ Reference may here be made to the various proposals in the United Kingdom over the last decade for reform of the CVA procedure; see now the Insolvency Act 2000, s 2 and Schedule 1.

important breathing space that the moratorium allows. At the same time, it is hoped that the proposal strikes a fair balance between the interests of the employees and of the company's other creditors, as well as promoting fairness as between different groups of employees.

Table A: Comparison of Treatment of Outstanding Workers' Wages under Various Insolvency Procedures⁴⁹

The position of employees in respect of unpaid wages is set out in the following table (similar, if not greater, disparities exist in relation to severance payments).

Type of case	<u>compulsory winding up</u>	<u>creditors' voluntary liquidation</u>	<u>receivership</u>	<u>provisional supervision</u> (the Corporate Rescue Bill)	<u>Alternative proposal</u> (suggested by Smart & Booth)
Amount	\$36,000 (max)* from PWIF	\$8,000 (max) under s. 265, as preferential creditor	\$8,000 (max) under s. 79, as preferential creditor	<i>all debts</i> <i>(no limit)</i>	\$36,000 (max) as employee protected debt in provisional supervision
<u>Time limit</u>	no wages outside 4 month period	no wages outside 4 month period	no wages outside 4 month period	<i>no time limit</i>	no wages outside 4 month period

* In a compulsory winding up, an employee's claim as a preferential creditor for outstanding wages is \$8,000; that sum is often claimed by the PWIF, having already made (larger) payments to the employee from the Fund.

⁴⁹ From this Table it is apparent why employees will seek to get legal aid and present a winding up petition, even if a company is already in voluntary liquidation: see *Re Rena Gabriel HK Ltd* [1995] 2 HKC 273.