**Hong Kong Society of Accountants**

**Comments on the "Consultation Paper on Corporate Rescue and the Protection of Wages on Insolvency Fund (Treatment of Employees in 'Provisional Supervision')"**

Our starting position is that Hong Kong needs a structured corporate rescue procedure. The Law Reform Commission (LRC) concluded from consultation on its preliminary report on the subject that: "The balance of opinion was strongly supportive of the introduction of measures such as those proposed" ("Report on Corporate Rescue and Insolvent Trading", October 1996, paragraph 1.16). The LRC went on to say: "In our view, it is beyond dispute that it is better for a viable business to survive as a going concern, in whole or in part, than for it to be simply wound up and such assets as remain distributed. It benefits the company's shareholders, as if the company survives, their share holdings might become valuable, whereas if a company is insolvent and would up they get nothing. It benefits the ordinary creditors of the company if they obtain more from a company reorganisation than from a dividend in a winding up, with the added benefit that they would keep a customer. It has become increasingly clear that secured creditors, usually banks, must look beyond the notion that being secured means that they are not affected by the winding up of a client company. Employment that would otherwise disappear would be preserved, at least to some extent" (paragraph 1.18).

The advantages of a corporate rescue over a liquidation cannot be over-emphasised. Apart from the immediate social costs of a liquidation, arising from the loss of employment, there may also be a substantial a knock-on effect within the business sector as trade creditors, particularly small creditors who tend to rely on one or two trading partners for their own businesses, may find themselves in financial difficulties as a result of the liquidation.

The issue therefore is not the cost of Provisional Supervision but the cost of delaying its introduction, or not having it at all, in an environment where unemployment and business failures in Hong Kong are rising to unprecedented levels.

It goes without saying that any procedures that are introduced must offer potential benefits to all the main parties involved and must be practicable. As one of the main interested parties employees should not be worse off than they would be in a liquidation, which is the likely alternative scenario to a corporate "voluntary arrangement". However, it is important not to lose sight of the fundamentals. Provisional Supervision is intended to, and should, save jobs, Whilst it may not be the case that all employees will be retained in many Supervisions, it would be misleading to suggest that a rescue will come only at the expense of all or the vast majority of jobs. There is also the potential saving of jobs in other businesses that rely heavily on the company undergoing rescue procedures, i.e. the prevention of job losses from the knock-on effect referred to above.

The Government's Consultation Paper outlines four possible options for payment of the entitlements of workers laid off and the arrears of wages of those retained. While the source of funding is ultimately a policy matter, as potential Supervisors, our members who are insolvency practitioners are in a position to indicate the practical problems with

particular proposals. We now outline these before clarifying certain apparent misconceptions and indicating our preferred approach.

*Option B*

*To make the employer liable for all Employment Ordinance entitlements, including clearing all arrears of wages before the company undergoes Provisional Supervision.*

It needs to be appreciated that a company embarks on a rescue when it is facing financial difficulties and that without the facility of a structured arrangement with its creditors it is likely that it would go into liquidation. Requiring an employer to settle all outstanding liabilities with employees before entering into Provisional Supervision, firstly, is likely to be impossible from the point of view of cash in hand or available from any external source; secondly, it amounts to giving employees a substantial preference over all other creditors, which means that other creditors may well be unwilling to enter into a rescue agreement because they will believe that they could be worse off than in a liquidation, i.e. they may consider that it is they who are subsidising the employees benefits; thirdly any money used by the employer to pay workers entitlements, if sufficient is available, which as suggested above is unlikely, will deny the maximum flexibility to the rescue process itself which is essential to save the business (i.e. since liquidity problems are what usually drive the need for rescue in the first place); and fourthly from a practical standpoint it will be only when the procedure has commenced that it will be evident how may employees are able to be retained and therefore it will not be possible for the employer to know the full extent of his liabilities before undergoing Provisional Supervision.

We would also point out that the procedure entails the appointment of an independent professional to take over control of the company. One of the reasons for the onset of financial problems may well be management deficiencies or lack of proper financial controls which lead the company into excessive debts, even though the core business itself might be sound. It makes little sense therefore to put the onus on the employer to be able to settle all outstanding liabilities to workers before entering into a rescue and in practice this requirement would be likely to push many troubled companies into liquidation as they would not be able to afford to go into a rescue. Thus the whole object of the exercise would be defeated.

*Option C*

*Exempting all employees from the moratorium and allowing them to preserve their right to present a winding-up petition*

This will in effect allow a single disgruntled employee to prevent the rescue proceeding and, as the Consultation Paper acknowledges, would undermine the aim of the moratorium which is to give a company breathing-space protection from creditors. Employees, as indicated above, represent one of the main categories of interested parties in a rescue and it would therefore be illogical for them not to be participants in it. It would also potentially give individual employees disproportionate bargaining power in

relation, for example, to demands to be retained. At the very least, it is likely that any employees not retained would expect to have the debts due to them from the employer immediately satisfied in full, which would also bring about the problems outlined in *Option B* above.

*Option D*

*Widen the ambit of the Protection of Wages on Insolvency Fund (PWIF) to allow employees to get quick relief but provide for the PWIF to be able to claim reimbursement in full as a priority debt*

This proposal is also subject to the deficiency mentioned in relation to *Option B* above, that other creditors may perceive themselves to be likely to be worse of than in a liquidation and so not support Provisional Supervision. In a liquidation the PWIF is able to reclaim only the statutory levels of preferential payments under section 265 of the Companies Ordinance (Cap 32) as a priority debt and is an ordinary creditor for any other amounts that it has paid out to employees. As indicated in the Consultation Paper, the statutory limits are substantially less than the levels which the PWIF currently pays out to employees in an insolvency. Given the difference between the Companies Ordinance and the PWIF levels, an indirect effect of this proposal is that it would almost certainly result in considerable pressure to align the statutory and the PWIF ceilings because it would be difficult to justify a discrepancy between the amount that the PWIF could reclaim in a corporate rescue and the amount that it can recover in an insolvency. However, such a change would face strong objections from other potential creditors in a liquidation whose own interests would be adversely affected, and it would be difficult to justify from a philosophical point of view as the considerations that bear on the levels prescribed in the Companies Ordinance are not the same as those affecting the PWIF levels.

It is our view, therefore, that none of the above options is workable or capable of bringing about a successful corporate rescue procedure. As we have indicated, finding an appropriate source of funding for employees' entitlements is primarily a policy matter. However, we believe that certain misconceptions that appear to stand in the way of exploring *Option A* further should be laid to rest. We will now turn to these.

*Option A*

*To expand the ambit of the PWIF to cover the employees affected by Provisional Supervision*

This is said to be the option proposed by the LRC. While indicating that it would be desirable for employees to be accommodated under the provisions of the PWIF Ordinance (paragraph 5.42 of the Report on Corporate Rescue) the LRC proposes at paragraph 5.43 of the Report "the introduction of a provision along the lines of section 79 of the Companies Ordinance to the effect that, where a provisional supervisor is appointed to a company the debts of employees which in every winding-up are

preferential payments under section 265 of the Companies Ordinance, be paid in priority to all other debts according to their respective priorities under section 265, out of the assets coming into the hands of the provisional supervisor in priority to any other claim". Section 79 of the Companies Ordinance deals with the situation in which a receiver is appointed and it makes provision, where the company concerned is not being wound up, for priority debts to be paid in accordance with section 265 out of monies coming into the hands of the receiver. There is therefore a precedent for applying the preferential payments under the Companies Ordinance in situations other than a pure insolvency. We believe that in introducing Provisional Supervision it is advisable to retain the basic structure of the existing legal framework and we would therefore support this proposal. The Consultation Paper points out that the limits under section 265 fall far short of those under the PWIF and therefore there is no incentive for employees to accept this arrangement. This is no doubt the case but it remains an argument for the PWIF being subrogated as a priority creditor, assuming that it does pay out in Provisional Supervision, only up to the section 265 limits. This preserves the principles of the existing framework (with the advantage that in a rescue, with jobs saved, the total payout by the PWIF should be smaller than in a liquidation / receivership) and prevents the creation of the disparity referred to in the context of *Option D.*

What are the concerns in providing for the PWIF to accommodate employees in a Provisional Supervision? Firstly there is the initial issue of expanding the ambit of the PWIF. We reiterate that this is ultimately a matter of policy, but it should be noted that in other jurisdictions which have a similar corporate rescue procedure, this procedure is often regarded as akin to an insolvency or is deemed to be an insolvency from the point of view of triggering payments that may be available to employees in an insolvency (e.g. in the UK this includes payments from the National Insurance Fund).

Secondly, there is the issue, referred to at paragraph 10 of the Consultation Paper, of possible abuse of the scheme by unscrupulous employers trying to relieve themselves of their statutory obligations to pay employees upon termination of service under the guise of a corporate rescue, that is, trying to pass the responsibility to the PWIF. We believe this issue to be more theoretical than practical and that the vast majority of employers whose businesses are candidates for Provisional Supervision are unlikely to be motivated in this way. In reality it would make little sense for any employer's point of view. Under Provisional Supervision the control of the company will be put into the hands of an independent third party who apart from being accountable to creditors who take part in the scheme, will be subject to the oversight of the Official Receiver's Office and, in all likelihood, one of the statutory professional bodies. The employer will also be unable to pay off his other creditors because of the moratorium. It is doubtful that any employer would want to run the risk of committing commercial suicide simply to avoid paying out termination payments to his employees. Furthermore, a Supervisor would have no interest in taking on a "rescue" which was simply a device for the employer to avoid his statutory responsibilities. It is essential to a voluntary arrangement that there must be a reasonable chance of a viable business emerging, in some form, before it can proceed. In the final analysis, if any employer seeks to walk away from his responsibilities and set up another business, this can and should be dealt with by means of suitable sanctions, which

should be introduced as part of an overall legislative package. Perhaps the most obvious avenue would be to consider expanding the existing disqualification of directors provisions under the Companies Ordinance to include the circumstances surrounding an application for Provisional Supervision.

Thirdly, there is the suggestion that because the PWIF pays less than the Employment Ordinance entitlements, the LRC proposal to expand the ambit of the PWIF to cover rescues could be breach of that Ordinance. This is to ignore the fact that in practice the most likely alternative to a rescue is a winding up, in which clearly the Employment Ordinance entitlements would not be paid. Similarly, with a strict application of the Employment Ordinance requirement that an employer should not continue a contract of employment "unless he believes upon reasonable ground that he will be able to pay wages due⋯as they become due" and if he does not so believe "shall forthwith take all necessary steps to terminate the contract in accordance with its terms". To treat a company which is undergoing Provisional Supervision as a "going concern" just like any other is to miss the point of the procedure. Such companies, while they have the potential to be saved, are, at the point of embarking on a rescue procedure, faced with severe financial difficulties and need a breathing space to come to a realistic and mutually-beneficial arrangement with their creditors.

Fourthly, there is the question of the financial position of the fund. It is doubtful that expanding its ambit would lead to a massive depletion of the PWIF. Again it must be emphasised that any payments that are made from the Fund in a rescue should not be regarded as additional to, but instead of, monies paid out in a liquidation of the company. The existing statutory mechanisms of receivership and liquidation result in the PWIF in effect picking up the bill for all employees, even where they are subsequently rehired by the buyer of the assets from the receiver or liquidator. In a rescue the main financial responsibility of the PWIF would be for the net job losses. So, if in a Provisional Supervision involving 100 workers, 60 are retained, then these are 60 workers who will not be making claims against the PWIF for termination payments who would otherwise be likely to be making such claims. This represents a potential reduction in the financial burden on the PWIF, not an additional burden.

Ultimately, it should be recognised that an annual levy of HK$250 per business registration is not a significant sum in the scheme of things and if it became necessary to increase this by a moderate amount it would have a negligible effect on the cost of doing business in Hong Kong and should not be an argument for preventing the introduction of a workable rescue procedure. It is a levy paid by the business sector and Provisional Supervision is an arrangement that is specifically intended to help businesses. In this respect there would appear to be nothing incongruous in using the PWIF to assist employees in Provisional Supervision as well as in liquidations, albeit that this may require some legislative amendments. Such changes would be primarily technical rather than major conceptual changes. In addition, the PWIF was set up to assist employees and Provisional Supervision, as we have emphasised, is intended to save jobs. As alternatives to increasing the levy across the board, if this became necessary, and it is not clear that it

would, consideration could be given to basing the levy on the size of the company or to designating a larger share of the business registration fee for the purpose of the PWIF.

It will be evident from the above that we believe a version of *Option A* ought to provide a workable solution to the problems posed in the Consultation Paper and should be further considered. In relation to this option, we would suggest that in allowing employees who have been laid off to claim from the PWIF, consideration may also need to be given to permitting employees who have been retained to claim some immediate relief for arrears of wages. At the least, thought should be given to earmarking a contingent amount within the PWIF for employees who are retained, to cover any arrears of wages prior to the adoption of their employment contracts by the Provisional Supervisor, in the event that a voluntary arrangement is not agreed by the creditors and the company is wound up. If claimed, these amounts would also become a priority debt, recoverable by the PWIF by subrogation, up to the statutory limits.

In conclusion, we consider that, generally, the concerns raised in connection with *Option A* are either not well-founded or can be dealt with satisfactorily. In addition, implementing this option should not require any radical alteration of the basic principles of the existing legal framework. The other options meanwhile could not bring about a successful corporate rescue procedure and doing nothing at all cannot be regarded as a reasonable alternative. The social and commercial costs of inaction in terms of the increasing loss of employment, the growing volume of liquidations and, ultimately the damage to Hong Kong's reputation and attractiveness to overseas investors, are, we believe, much greater than the limited risks of possible abuses or any technical problems to which a structured corporate rescue procedure might give rise. Currently, any restructuring does not enjoy legislative protection and often receivership or liquidation, with all their associated disadvantages to the PWIF and the businesses community, are the only statutory avenues available. Now, more than ever, Hong Kong needs to introduce a corporate rescue culture in order to assist in restructuring its businesses to enable them to face the changing environment and to preserve as many jobs as possible.

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