Letterhead of Philip Smart

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The Hon Ronald Arculli, JP
Chairman,
Bills Committee
(Companies (Amendment) Bill 2000)
Legislative Council
8 Jackson Road
Hong Kong

FAX 2869 6794 9 pages in total

24 March 2000

Dear Sir,

Re: Companies (Amendment) Bill 2000

I wish to comment upon the above Bill as it relates to corporate rescue and provisional supervision. As you will see from the attached documents, I was earlier this year in correspondence with the Office of the Official Receiver in relation to several points in the Bill. There is, however, *one point* that particularly concerns me and which I would wish to draw to the attention of the Bills Committee. It concerns the position of secured creditors.

When reading the Bill I saw no provision which made it clear that secured creditors would be fully protected in the event of a company going into provisional supervision. Leaving aside the veto given to a major secured creditor under s.168 ZQ, I could find nothing in the Bill to prevent a plan being proposed (for example) that all creditors *including secured creditors* would receive, let us say, 50% of their debt over the next three years. (Unsecured creditors would, of course, be very much in favour of the sort of proposal in my example.) The position in, for example, the UK, Australia and even the USA, is that the secured creditors cannot be forced to 'take a haircut' (or to swap debt for equity etc) against their wishes. I raised this point with the Office of the Official Receiver and was informed that the intention behind the draft legislation was that secured creditors (except to the extent that a major secured creditor was given a power of veto under s.168ZQ) were to be treated just like other creditors and could indeed be required to take a haircut (even against their wishes).

In my opinion, such a position is completely untenable. Its effect would potentially be to undermine the very basis of secured lending in Hong Kong. A bank, for example, even if it took a perfectly valid and proper charge on the company's assets could not be sure that, at some time in the future, the company would not enter into provisional supervision and in due course a plan be proposed - and voted on *by all the creditors* in a single meeting - requiring *all* creditors to give up 80% of their debt. Unsecured creditors might very well be in favour of such a proposal, since their position in the event of an insolvent liquidation would normally be pretty hopeless.

But a secured creditor, where a company goes into liquidation, is often in a very different position and can often expect a substantial return (albeit not always 100%). I believe there has been some confusion over the position of secured creditors under the proposed provisional supervision. I have recently spoken to the Chairman of the Insolvency Law Sub-Committee (Professor Tyler) and he informed me that it was never the intention that secured creditors could be forced to take a haircut.

In short, there can be no justification for the rights of secured creditors in Hong Kong to be so radically affected. The position in other major jurisdictions, even in the US, is that secured creditors are given adequate protection. That position must be adopted in Hong Kong too, I would suggest.

Finally, although my letter to the Official Receiver points out a number of issues in the Bill which I consider less than satisfactory, any rescue legislation is to be welcomed－provided that it does not radically alter the basis of bank lending in the territory!

Yours sincerely,

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Associate Professor

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Dear Eamon,

Corporate Rescue

I spent a while earlier this week looking at the Companies (Amendment) Bill 2000 in relation to corporate rescue. I have a number of observations and I hope you will not mind if I draw your attention thereto.

(The legislation is very complex, so it may be that despite my checking and re-checking there may be answers to one or more of my points somewhere in the Bill. If there are things I have overlooked, I apologize.)

1. Structure of the Legislation

Firstly, the proposed Part IVB seems to me to be extremely complex - it is one of the most difficult pieces of legislation I have came across recently. In my view this is a particular problem since difficult legislation will tend to increase costs. One problem with the type of corporate rescue mechanism suggested by the Law Reform Commission was always going to be whether it would be prohibitively expensive for the great majority of companies in financial difficulty. Very complex drafting not only directly increases costs but also does so indirectly - this legislation is perhaps so difficult that only a small number of firms of accountants in Hong Kong may have the expertise and confidence to get involved.

2. Workers' Wages etc

I am, of course, aware that a policy decision was taken in respect of wages etc owed to employees. This is now reflected in s.168ZA(C)(IV)A(II). (I hesitate to mention complexity again.) As far as I can see, whilst the workers' wages are 'guaranteed' as it were by the trust account, there is nothing in the Bill to prevent the workers from voting at the creditors' meeting. The workers will (as far as I can see) still be creditors until they are paid off - which must surely be after the plan is approved and put into effect. It cannot, I think, be that the workers are paid off straight away - for no workable proposal may eventually be prepared or approved and liquidation ensues (or resumes)

My point is whether it is fair that the workers can vote at the creditors meeting, when their vote is a foregone conclusion - as they will be better off than under any other

scenario (who else will get 100%?). I find unattractive the idea that a situation might arise where a proposal is only approved because the workers vote in favour and tip the balance in favour of the proposal. On the other hand, 'disenfranchising' the workers is not wholly without difficulty.

I have rejected the idea that the trust account actually creates a true trust, under which each worker becomes a beneficiary for a fixed amount. This cannot (?) be the case, since no rescue proposal may eventually result. The most there could be is a Quistclose trust; and, in any event, the House of Lords is adamant that, even if there is a trust, a trust can co-exist with a creditor relationship. In short, the workers remain creditors, but how are they to be treated when it comes to voting?

As I mentioned earlier, I am aware that a policy decision has been taken in respect of workers' wages, but does this not also create some inconsistency. Section 168Z informs us that a proposal can be formulated to help the company survive in one form or another. But another reason for a proposal is the more advantageous realization of the company's assets than would be achieved in a winding up. In other words, the company's assets are going to be liquidated but it may take place not immediately but in a year or two (or whatever). I find it difficult to understand why one set of rules should apply to workers where there is going to be an immediate liquidation of assets (the normal winding up) but a quite different set of values applies where the liquidation of assets is going to occur over a longer time frame.

In any event, my main point here is that - even accepting the policy decision without reservation - the voting rights of workers should be addressed.

3. Connected Persons

Let me give an example. A situation might arise where at the creditors' meeting a majority of 'independent' creditors (by which I mean trade creditors, banks etc) are against the proposal, but the directors (who have funded their business through loans rather than share capital) have enough voting power to carry the day. Such directors may have more reason than independent creditors to wish to avoid a liquidation - not only may they keep their jobs, but they may also prevent avoidance actions being pursued by a liquidator. If we see this type of case early on after the legislation is introduced, creditors could become very skeptical of the regime. (I understand that the CVA in the UK has specifically addressed this voting issue.)

4. Secured Creditors (i): Veto

I note that s. 168ZQ gives a veto to any major secured creditor. I am not sure why a veto should be given to a creditor who holds at least 33.3% of the total debt secured under a (single) charge, but not given to a creditor who holds the specified percentage under two or more charges. Banks often take several charges at different times as a business

expands etc. (Also, technically, would it not be better to refer to 'the amount secured by the charge' rather than 'the claim under the charge' - the claim is not under the charge.) Also, I realize that picking any particular percentage (10%, 20% etc) is arbitrary, but it does strike me that very few chargeholders would qualify for the veto as currently drafted.

More importantly, I have difficulty with any notion of a percentage. Unnecessary work may well be being created (see the arguments about costs above). For the provision to operate the provisional supervisor ('p.s.') may have to work out (a) the total indebtedness of the company and (b) what is owed to a particular secured creditor and how much is secured under each of the charges that creditor has. Sometimes, the answer to the question whether X falls under s. 168ZQ will be obvious one way or the other. But cases will arise where this is not so. I seem to recall that in BCCHK and Peregrine it was a very difficult process to work out what the actual liabilities were. I also have in mind any case involving a group of companies where cross-guarantees have been given: it may be months before all a particular company's liabilities can be calculated.

These sorts of difficulties may be contrasted with the position that prevails where the legislation says something along the lines of: 'if you have a specified charge you get a veto'. All one has to do is look at the register of charges. I appreciate that the LRC was concerned with lightweight charges, but I would suggest that that particular problem should be addressed without requiring percentages of total liability.

This costs question also arises in relation to the workers trust account in s. 168ZA(C)(v)A - as there is no cap per employee, it is possible to imagine cases where not inconsiderable hours are spent calculating 'all debts and liabilities owing' to employees under the Employment Ordinance.

4. Secured Creditors (ii): Prejudice

I am probably being very dense ... but ...

May I ask whether there is anything in the Bill currently to prevent a proposal that all creditors, including secured creditors, take a haircut. (To make it simple I am assuming no veto arises or, alternatively, the veto has not been exercised.) I know it was the intention of the LRC that secured creditors be fully protected (see para 13.A) (although receivers could not be appointed) but I cannot find that protection spelt out in the Bill. Perhaps something along the lines of IA 1986, s.4(3) might be added to s. 168ZS(1)?

Anyway, apologies if I have overlooked a provision already in the Bill.

5. Shareholders

Again I may be missing the obvious, but I can see no provision in the Bill for approval of the proposal by the shareholders. This would seem to be deliberate since no mention of a shareholders' meeting appears in the reports of the LRC. (I also am aware of the situation in Australia.)

A voluntary arrangement is defined in s. 168U to mean a compromise or arrangement and is declared to be binding on, inter alia, the shareholders (s. 168ZU(1)(b)(iii)). It is easy to imagine rescue plans where shareholders inject fresh capital, debt is converted into equity, new classes of shares are created (or existing classes cancelled), the company's paid up share capital is increased or decreased, and amendments need to be made to the company's articles and so on. It just seems a bit strange to me that shareholders have no say in the proposal's approval where such issues arise (although the members may appoint a p.s.).

6. Utilities

The Bill has, I think, no provision to prevent 'commercial blackmail' by utility companies. I would have thought such a provision would be of some use particularly in a corporate rescue mechanism (if not throughout corporate insolvency law). I do not think the issue was ever discussed by the LRC. Again, I may have missed something (I note s. 30E of the Bankruptcy Ordinance and suggest the equivalent here).

7. Tricky Directors

The non-availability of statutory avoidance powers to the p.s. might create unhappy situations (or at least, I can imagine them). Let us say that some of a company's directors have engaged in transactions at an undervalue or given preferences to associated companies etc. Let us also say that creditors are threatening to petition and that if a winding up were commenced now the relevant transactions would fall within the statutory time-frames, but if 3 or 4 months elapse those time periods will have passed. The directors go for provisional supervision and in due course a proposal is formulated and approved by the creditors. All this takes 3 or 4 months. But the company then fails properly to implement the plan and the supervisor petitions for winding up pursuant to s. 168ZW(3)(c). Here there is no backdating provision, so the directors cannot be brought to book by the liquidator (and the p.s. does not have the statutory powers).

In conclusion, I have a variety of other lesser observations, as well as one theoretical point of a true academic nature (which no one would be interested in), but for now I think enough is enough.

With best regards,
Yours sincerely,

Philip Smart.

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28 February 2000

Dear Eammon,

Corporate Rescue

Thank you for your letter of 21 February 2000 and for the detail of your response. I am reluctant to add anything more—I have already said enough—but I hope you will permit me a few further observations.

Secured Creditors: Prejudice

I remain very concerned at the idea that secured creditors can have their rights diluted without their consent. I would have thought such an idea was revolutionary (if not heresy). It should have been extensively debated, yet I have re-read Chapter 13 ("Secured Creditors") of the Insolvency Sub-Committee's Paper and cannot find such a suggestion there. Indeed, Para 13:13 says the opposite in clear terms (at least, I think so). The downside to allowing provisional supervision to dilute secured creditors' rights is potentially enormous, I would have thought, in terms of whether the dilution of secured creditors' rights would affect the lending practice of banks in Hong Kong?

I would very much hope that the policy behind this approach to secured creditors can be reconsidered. If not, I would suggest abandoning the Bill altogether.

Secured Creditors: Veto

I too observed the connection between 66.6% and 33.3%. However, my comments would be as follows: (1) a creditor who holds > 33.3% does not <u>need</u> a veto (as he has one in practice anyway); and (2) if the percentages are important, then this does not relate to whether the relevant creditor is or is not <u>secured</u>. Is the veto there because the creditor is secured or because in practical terms no rescue can go ahead without his approval? There seems to be a lack of conceptual clarity (although that may not worry anyone except the odd academic!)

As to ascertaining the amount of liabilities, here again I have the misfortune to disagree with you. It seems that provisional supervision is only intended for large scale rescues. These are likely to involve businesses which have a group structure - although only one company may be in financial difficulty - and where cross-guarantees are a factor. I would also suggest that reference to the s.168ZN statement of affairs may often not be helpful. The provisional supervisor has only 3 days after the relevant date to inform major creditors: but directors have 7 days after they get notice under s.168ZN (that notice may even not be given on the relevant date, but a day or two later).

Workers Wages

If the policy is that workers should not be entitled to vote, then it might be worth spelling this out in the legislation (perhaps by restricting the definition of who is a 'creditor').

Connected Persons

I can only say that is both the UK and Australia (which seems closer to the HK Bill) there are safeguards in relation to connected persons/related parties and unduly influencing the result. Such parties clearly have different interests than ordinary trade creditors, for example. Whether such safeguards are appropriate for HK is a policy matter.

Tricky Directors

My interpretation of ss. 168ZS(5)(b) and 168ZT(17)(a)(I) is that they do not apply in the situation I suggested. My reading is that those provisions apply where the rescue proposal is not accepted; they do not appear to apply where the proposal is accepted by the creditors' meeting but later on it fails (because e.g. of the company's lack of cooperation) when the voluntary arrangement plan is being put into operation.

With best regards,
Yours sincerely,

Philip Smart