Submission on

Companies (Amendment)

Bill 2000

PRICE WATERHOUSE COOPERS

CONTENTS

1. Executive summary

2. Detailed comments

   A. Provisional supervision and voluntary arrangements - Part IVB

      - Right of veto - major creditors
      - Provision for employee entitlements
      - Claims by directors and related persons
      - Appointment of a Provisional Supervisor to solvent companies
      - Ability of creditors to choose Provisional Supervisor
      - Creditors' committee
      - Statement of affairs
      - Calculation of creditors claims
      - Powers of the Provisional Supervisor
      - Provisional Supervisor's liability for employee claims
      - Moratorium
      - Report of the Provisional Supervisor
      - Rights of secured creditors
      - Employees trust account on liquidation
      - Comparison to Schemes of Arrangement
      - Section references

   B. Insolvent trading

      - Liability of managers
      - Liability of professional advisors

   C. Appointment of provisional liquidators under s.228A

   D. Panel B

   E. Other recommendations

COMPANIES (AMENDMENT) BILL 2000
EXECUTIVE SUMMARY OF MAIN SUBMISSIONS

Provisional Supervision

Overall we consider the implementation of a regime of formal workouts incorporating a statutory moratorium on claims as a very positive step for Hong Kong and are aware of many instances where such a procedure for dealing with companies in financial difficulties would benefit the company, its' employees and creditors in general

Our submissions principally concern the practical application of the procedures:

⇨ the procedure should only apply to companies in financial difficulty (which should be defined)

⇨ the rights of secured creditors should not be compromised through a voluntary arrangement without their prior consent, otherwise the effectiveness of the procedure will be limited.

⇨ the requirements for payment of employee claims in full or through a trust account are likely to restrict the effective application of the provisions. The prospect of a company continuing to trade (and therefore preserving employment) is a fundamental benefit to employees and should be encouraged rather than restricted.

Insolvent trading

Generally, we welcome the proposed introduction of insolvent trading provisions in Hong Kong. The current provisions on fraudulent trading require a burden of proof that is too high to enable effective prosecution under this section.

⇨ liability for insolvent trading should however be limited to directors and shadow directors only, not against employees of the company.

⇨ professional advisors should not be liable for insolvent trading when properly acting in a professional capacity, in order to encourage companies to benefit from specialist advice in difficult financial circumstances.

Appointment of Provisional Liquidator under s.228A

We disagree with the proposed abolition of section 228A, as it provides for a cost effective and prompt procedure to appoint a provisional liquidator and commence liquidation procedures in circumstances of insolvency.

COMMENTS ON THE COMPANIES (AMENDMENT) 2000 BILL

A. PROVISIONAL SUPERVISION AND VOLUNTARY ARRANGEMENTS - Part IVB

1. Overall we see the implementation of a regime of formal workouts as a very positive step for Hong Kong and are aware of many instances where such a procedure for dealing with companies in financial difficulties would benefit the company, its' employees and creditors in general. We strongly recommend to Legislators that such a law is necessary for Hong Kong and urge its' sensible implementation as soon as possible. However, a number of parts of the bill raise some concerns and we would like to draw your attention to the practical effects of implementation of the procedures.

Right of veto - major creditors

2. At present, the Bill allows for major creditors to veto the Provisional Supervision under s.168ZQ *after* a Provisional Supervisor has been appointed.

3. If a major creditor does not consent to the continuation of the Provisional Supervision, the Provisional Supervisor must vacate his office pursuant to s.168ZQ(2)(d).

⇨ We recommend that the directors of a company be required to serve notice under s.168ZQ *before* a Provisional Supervisor is appointed and if no objection is received within, say, three days, the directors would then be free to appoint a Provisional Supervisor. This would save the cost of

appointing a Provisional Supervisor if the major creditor does not give its consent.

Provision for employee entitlements

4. Under s.168ZA(c)(iv) Provisional Supervision cannot take place unless all the company's liabilities to its employees are either paid or provided for in full by way of establishment of a trust account.

5. We draw your attention to the fact that where the company has a large number of staff or a number of highly paid staff, this requirement will greatly restrict the ability of a company to implement the procedure. We do not think that it is the intention of the law makers to restrict the use of this procedure to companies with a small number of staff. In fact, as the intention of the Bill is, as far as possible, to "save" a company, this provision seems to be working against the very purpose of the Bill.

6. It should be noted that the greatest benefit to employees of this procedure must be the prospect of preserving the company and therefore their employment. If this procedure cannot be used except where there are a small number of employees, we question whether it will serve its' purpose.

7. It should also be noted that where the company is insolvent, realistically the only source of funding of payments to employees is likely to be the extending of further credit (unknowingly) by the company's ordinary unsecured creditors or realisation of assets that could otherwise be used to pay ordinary unsecured

creditors. Thus it would appear that these provisions will encourage directors to prejudice the position of unsecured creditors by taking more credit from them in order to give employees a greater priority than they may otherwise have on insolvency. We question whether this is the intention of the Bill.

8. We support that certain of the claims of employees should be protected above those of ordinary unsecured creditors. There are two ways in which the law already provides for this in a liquidation situation:

- Payments by the Protection of Wages on Insolvency Fund; and
- Giving priority, above ordinary unsecured creditors, to employee claims

9. To protect employees, priority could be given to employees over claims of ordinary unsecured creditors in a voluntary arrangement. If thought appropriate, "complete" protection could be given by providing that no voluntary arrangement can be entered into unless the arrangement provides for employees claims to be paid in full, although we question whether such complete protection is necessary.

⇨ Abolish the proposed requirement under the Bill for payment of employee claims in full or through a trust account. Recognise that the prospect of continuation of trading by a company (and therefore continuation of employment) must be a fundamental benefit to employees and their major concern. Provide for protection for employees through other means, such as statutory priorities or payments made under the Protection of Wages on Insolvency Fund Ordinance.

Claims by directors and related persons

10. In our experience, the largest employee claims in an insolvency situation generally come from directors, usually because they tend to have higher salaries and other benefits than ordinary employees. In many instances, the directors will be regarded as being largely responsible for the financial condition of the company.

11. We therefore question whether it is the intention of the Bill to ensure that directors and related persons' remuneration is afforded a level of protection ahead of other creditors, like other employees.

    ⇨ The claims of directors and related persons should rank as ordinary unsecured creditors and should not be required to be either paid or provided for in a trust account before the appointment of a Provisional Supervisor.

Appointment of a Provisional Supervisor to solvent companies

12. The Bill quite clearly proposes that a Provisional Supervisor may be appointed to a solvent company. In particular, s.168Y(2)(a) provides that
    "...the appointment of a qualified person to be the provisional supervisor of the company may be made - (a) whether or not the company is able to pay its debts."

13. A similar regime to Provisional Supervision is Chapter 11 in the American Bankruptcy Code. We understand that Chapter 11 has been used by solvent companies to avoid liabilities, e.g. by contracting out of employees' statutory rights due to changes in labour laws. We can also foresee instances where

Provisional Supervision may be used by solvent companies to escape from large contingent liabilities such as those faced by tobacco companies, pharmaceutical companies, etc. We question whether this is the intention of the proposed law. If not, we question why Provisional Supervision should be made available to solvent companies.

14. As discussed in greater detail in paragraphs 47 to 49 below, it is still possible, albeit difficult, for solvent companies to be restructured under s.166 of the Companies Ordinance - Schemes of Arrangement.

15. If our recommendation is implemented, a definition of insolvency would need to be included in the Bill. By way of example, we refer to s.95A of the Australian Corporations Law, which provides a seemingly workable definition of solvency, namely:

    (1) "a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.

    (2) a person who is not solvent is insolvent".

16. S.436A of the Australian Corporations Law also provides for when a company may appoint an Administrator (the Australian equivalent of a Provisional Supervisor):
    "A company may, by writing, appoint an administrator of the company if the board has resolved to the effect that:

    (a) in the opinion of the directors voting for the resolution, the company is insolvent, or is likely to become insolvent at some future time; and

    (b) an administrator of the company should be appointed"

⇨ We recommend that the use of Provisional Supervision should be restricted to insolvent companies or companies likely to become insolvent only. Insolvency should be a defined term.

Ability of creditors to choose Provisional Supervisor

17. Unlike other insolvency administrations currently in force (i.e. compulsory and creditors voluntary liquidations) there is no provision in the Bill to enable creditors to be consulted in the appointment of a Provisional Supervisor.

⇨ We recommend that a meeting be held shortly after the appointment of a Provisional Supervisor, (say, within 7 days) with a limited agenda to:

- Confirm the appointment of the Provisional Supervisor, or to replace him with another if so resolved by a majority of creditors;
- Appoint a creditors' committee (see comments below); and
- Receive a statement of affairs from the directors (see comments below)

Creditors' committee

18. In liquidation administrations, a committee of inspection can be of great assistance to an appointee. Functions of the committee include extending the appointee's powers, where needed, submitting creditors' views and approving the appointee's remuneration.

19. We consider that a Committee forum is much more conducive to creditors obtaining information, asking questions and discussing proposals and for the

Provisional Supervisor being able to answer them than a large meeting of creditors.

20. Remuneration of appointees is an area which has come under considerable scrutiny in recent years. It is our experience that it is difficult for a large body of creditors to properly consider the fees of a Provisional Supervisor. The format of fee invoices required by the Official Receiver's office in other insolvency administrations is detailed and complex. We submit that it is not reasonable or practical to ask a large body of creditors to review and approve such invoices in the level of detail required. Such matters would be better dealt with by a committee representing all creditors.

    ⇨ As recommended in paragraph 17 above, a creditors' committee should be appointed to assist the Provisional Supervisor in his duties and approve his remuneration.

Statement of affairs

21. Under s.168ZN of the Bill, it is proposed that a Provisional Supervisor shall require a specified person to provide him with a statement of affairs of the company. A copy of the statement of affairs is not required to be given to creditors until the relevant meeting of creditors held under s.168ZR.

22. A statement of affairs is a document which is often difficult to obtain from specified persons. Reasons for this include lack of proper books and records, reluctance of specified persons to take responsibility or face up to the current

financial situation of the company, reluctance to co-operate with the appointee, etc.

23. If there was a statutory requirement for specified persons to produce the statement of affairs to their creditors within a short time frame, this would assist the effectiveness of the procedure. Also, early provision of a statement setting out the financial position of the company would give creditors some information on the status of their debts.

⇨ As recommended in paragraph 17 above, directors or specified persons should be required to produce a statement of affairs to a creditors meeting held shortly after the Provisional Supervisor's appointment.

Calculation of creditors claims

24. A major creditor is defined in s.168ZQ(5) as:

"the holder of a charge over the whole or substantially the whole of the company's property if, but only if, the claim under the charge amounts to not less than 33 1/3% of the liabilities of the company immediately before the relevant date."

25. In order for the Provisional Supervisor to calculate whether or not a creditor is a major creditor he must first determine the total liabilities of the company. There is no mechanism for such calculation set out in the Bill. For example, are the total liabilities of the company to be calculated on a gross or net basis (i.e. before or after the value of any security has been attributed)? What if the charge is only partly valid (e.g. because of the operation of s.168ZQ(4))? Is the unsecured portion of the debt to be ignored for the purposes of calculating the

one third percentage? Are guarantee claims to be included in the total amount of creditors claims? If so, are they to be included at the face value of the guarantee or the likely call value?

26. There appears to be no provision in the Bill for determining the claims of guarantee or contingent creditors. Guarantee and contingent creditors present a potential difficulty to a Provisional Supervisor.

27. What is the value of a contingent creditor's claim? By way of example, if a company in Provisional Supervision has given a guarantee to, say, a bank for loans extended to a third party. At the time the guarantor has a Provisional Supervisor appointed, the primary obligor (the third party) may not be in default and therefore at that point in time there would be nothing owing under the guarantee. However, is it fair and equitable for such creditors to be excluded from a Voluntary Arrangement and either have no voting rights or receive nothing?

28. We note that in large complex and group situations, determining creditors' claims can be time consuming. Furthermore we note that there is a large body of case law, both in Hong Kong and elsewhere, relating to creditor disputes in valuing claims.

29. The Companies Ordinance and Companies (Winding Up) Rules currently provide statutory means of establishing and calculating certain claims on liquidation.

⇨ We recommend that the Bill set out clear guidelines for establishing and calculating the value of creditor claims as well as a method of resolving disputes to ensure fairness and consistency.

Powers of the Provisional Supervisor

30. It is our experience that in situations of insolvency, directors, office holders, employees and related parties can be or become unco-operative to the appointee, in this case the Provisional Supervisor.

⇨ We recommend that the Provisional Supervisor be given powers of investigation similar to those of a liquidator, in particular under s.211, (delivery of property) s.221 and s.222 (public examinations) of the Companies Ordinance. This will enable the Provisional Supervisor to effectively take control of the assets of the company.

Provisional Supervisor's liability for employee claims

31. We agree that a Provisional Supervisor should not continue to employ staff unless he is able to pay them.

32. However, we note that the Bill does not specify which costs a Provisional Supervisor would be personally liable for. For example, presumably the costs include wages, but do they also include notice, severance pay, holiday pay, ORSO/MPF payments?

33. It does not seem equitable that a Provisional Supervisor employing someone for, say a month, would become liable for severance pay based on an employee's contractual obligations and entitlements prior to the appointment. A potential liability of this magnitude can presumably only encourage the Provisional Supervisor to terminate staff. We question whether this is the intention of the Bill

34. We note the difficulties encountered in the United Kingdom for employees claims in the case of *Paramount Airways Ltd (No.3)* [1994] B.C.C. 172 and question whether this situation has been explored and provided for in the current proposals.

⇨ We recommend that the personal liability of the Provisional Supervisor in respect of employee payments be clearly defined. We recommend that the liability of the Provisional Supervisor be limited in respect of employee payments, for say, wages based on a casual rate (i.e. not including holiday pay, severance pay, notice, etc.) for the period that the employment has been continued only.

Moratorium

35. We support the proposal for a statutory moratorium on claims during the Provisional Supervision period. This has been one of the shortcomings in other jurisdictions.

Report of the Provisional Supervisor

36. At the "relevant meeting" creditors are generally faced with three options:

- To accept the proposal put forth by the company
- To wind up the company
- To adjourn the meeting

37. Where the creditors are required to choose between the proposal and winding up, we believe that they need to know the full financial implications of both decisions. This means that they should fully understand both what they are likely to receive in liquidation and what they are likely to receive under the proposal. Creditors can only make this decision where the Provisional Supervisor examines means of recovery only available in a liquidation, for example, unfair preferences (s.266A), misfeasance (s.271), fraudulent trading (s.275), voidable dispositions (s.182), insolvent trading (s.295A).

⇨ Legislate to provide that the Provisional Supervisor must report on the likely return in winding up, including any possible recoveries available on liquidation such as antecedent transactions.

Rights of secured creditors

38. It has been brought to our attention by Mr Philip Smart of Hong Kong University that there is nothing in the Bill to prevent a proposal being formulated that forces secured creditors to accept less than they are owed or less than the value of their security.

39. Mr Smart advises that correspondence with the Office of the Official Receiver has suggested that it is the intention of the Bill that secured creditors can be forced to "take a haircut" by a vote of creditors on the proposal.

40. We agree with Mr Smart's comments (given at a meeting of the Insolvency Interest Group held on 27 March 2000), namely that this will re-write the law on bank lending in Hong Kong. That it is totally different from the position in a winding up and that it is at odds with practice in other jurisdictions world wide. We would go further to suggest that there will be no Provisional Supervision administrations able to be implemented where there is a major secured creditor as it would be in the major secured creditor's interest to veto any such proposals under s.168ZQ in order to ensure their rights are protected. Surely this is not what was intended.

41. By way of comparison, the UK Insolvency Act, 1986, s4(3) provides that:

"a meeting...shall not approve any proposal or modification which affects the right of a secured creditor of the company to enforce his security except with the concurrence of the creditor concerned."

⇨ We recommend that a provision be added to the effect that the rights of secured creditors can not be compromised by a voluntary arrangement without their consent. If this is not accepted, then we recommend provisions similar to those found in Chapter 11 (US) in respect of secured creditors be added wherein such creditors can only be compromised if by way of such compromise they receive the full entitlement of their claim.

Employees trust account on liquidation

42. The Bill does not provide for what happens to the employees trust account set up under s.168ZA(c)(iv) if the company is subsequently placed into liquidation.

43. Normally on liquidation, employees receive their entitlements in accordance with the priority afforded to them under s.265 of the Companies Ordinance. The Ordinance does not provide for employee entitlements to be paid in full on liquidation, rather there are defined limits for the preferential treatment of each type of entitlement.

44. The trust account proposed under s.168ZA(c)(iv) is not in accordance with those statutory priorities, as it seeks to meet employee claims in full.

45. Under s.266A and s.266B of the Companies Ordinance certain payments made in the six months prior to winding up at a time when the company was insolvent may be clawed back by a liquidator as an unfair preference. It is possible that payments from the employees' trust account may be considered an unfair preference, as the trust account would give employees a greater return than they might otherwise have on winding up.

⇨ If the employees' trust account is to be returned to a liquidator on liquidation we recommend that the Bill expressly provide for this to avoid confusion and court costs. If the employees' trust account is to be paid to employees on liquidation, we recommend that the Bill provide for this, making it clear that such payments cannot be an unfair preference.

Comparison to Schemes of Arrangement

46. We refer to the submission by Lingnan University. We respectfully disagree with the suggestion that the proposed Provisional Supervision can be replaced by an amendment to Schemes of Arrangement under s.166 to provide for a moratorium of creditors claims.

47. In our experience Schemes of Arrangement in Hong Kong have been very lengthy, costly and we believe can become complex (e.g. with respect to different classes of creditors and their respective voting rights). For these reasons we have only very rarely recommended their use.

48. We believe that Schemes of Arrangement certainly have their place (e.g. for insurance companies) and should not be abolished, however, there is also a strong need in Hong Kong for the additional type of arrangement proposed by this Bill.

Section references

49. We agree with the submission by the Hong Kong Society of Accountants in relation to the apparent inconsistencies in relation to section references. We see no reason to duplicate such submissions here.

B. INSOLVENT TRADING

50. Generally, we welcome the introduction of insolvent trading provisions in Hong Kong. The current provisions on fraudulent trading require a burden of proof that is too high to enable effective prosecution under section 275. We would like to raise two areas of concern with the proposed amendments.

Liability of "managers"

51. The Bill proposes to make "managers" liable for insolvent trading, s.295C. Whilst jurisdictions like the United Kingdom and Australia make "shadow" or "deemed" directors liable for insolvent trading, it is a jump to make managers so liable.

52. Directors have statutory responsibilities and duty of care to a company. Directorship is an appointment in which one has a choice in accepting. A manager, on the other hand, makes no express choice.

53. Manager, is normally a position of employment, rather than a strict legal term. Whether or not a manager knew or ought to have known that the company was insolvent is a function of his level of responsibility from that employment. He has no statutory right to review financial accounts of the company.

54. Alternatively, some form of registration of 'managers' such as for directors could overcome this use of terminology. The responsibility of managers can

vary widely from company to company and if what is intended is to widen the net then there should be a stricter definition.

⇨ We recommend that liability for insolvent trading be levied against directors and shadow/deemed directors only, not against employees of the company.

Liability of professional advisors

55. From time to time solicitors and accountants are asked to advise companies in financial difficulty on ways to better manage the business, restructure loans, etc. The proposed insolvent trading law does not specifically exclude professional advisors from liability for insolvent trading.

56. By way of comparison, s.168C of the Companies Ordinance defines a shadow director as:

"a person in accordance with whose directions or instructions the directors of a company are accustomed to act but a person shall not be considered to be a shadow director by reason only that the directors act on advice given by him in a professional capacity."

⇨ The company, its employees and creditors will benefit from proper professional advice provided by accountants and solicitors in difficult times. We recommend that such advice be encouraged by specifically removing persons properly acting in their capacity as qualified professional advisors from being liable for insolvent trading.

C. APPOINTMENT OF PROVISIONAL LIQUIDATORS UNDER S.228A

57. The Bill proposes to abolish the ability of directors to appoint a provisional liquidator under s.228A.

58. We respectfully disagree with the proposed abolition of this section for two main reasons. Firstly, the provision provides a cost effective, immediate and quick procedure for directors to appoint a provisional liquidator in circumstances of insolvency. We believe that it is particularly important to keep the provision in light of the suggested implementation of insolvent trading provisions, which require directors to take immediate action to avoid personal liability.

59. Secondly, whilst it will still be open to directors to apply to the court for the appointment of a provisional liquidator, this method can incur legal costs at a time when there are limited resources available to the company.

60. There are circumstances in which the only way a company can be dealt with is under this section. One such example is where shareholders agreements prevent other modes of winding up (whether under s.241 or application to the court).

61. From time to time there have been allegations of abuse of s.228A. We are not aware of any substantiated instances of abuse in practice. Also, we understand that neither the Law Society nor the Hong Kong Society of Accountants have received notification or complaints of abuse. To the contrary, we have seen

s.228A effectively used as a remedy to preserve and protect assets during the period prior to the appointment of a liquidator.

62. If the section must be abolished, we note that there are no transitional arrangements. For example, if the Bill is made law on 1 December 2000, what happens to a liquidation commenced under s.228A on 29 November 2000? Under the current outright abolition, it would appear to be illegal to continue with such an administration.

⇨ We recommend that s.228A remain as an additional procedure for dealing with companies in financial difficulty.

D. PANEL B

63. We support the proposed changes to allow the Official Receiver to appoint private sector liquidators to small liquidations.

⇨ We recommend that such appointments be made as soon as possible in the course of the liquidation, any delays compound the difficulties in locating directors and recovering assets.

E. OTHER RECOMMENDATIONS

64. We welcome and support changes to the law to provide for Provisional Supervision and insolvent trading. We also see a need for further changes to the law to ensure that Hong Kong can effectively deal with insolvency matters.

65. We recommend the implementation of a system to license insolvency practitioners. In all insolvency administrations, there is the potential for abuse. Also, insolvency administrations place a great deal of responsibility on the practitioner. Insolvency practitioners are licensed overseas and generally must comply with requirements as to professional ethics, experience and expertise. Hong Kong can only benefit from such a system. We note that it is proposed that the Official Receiver co-ordinate a panel of appropriately qualified practitioners to take appointments as Provisional Supervisors. This is certainly a necessary first step, but we recommend that Legislators go further to establishing an independent means of licensing practitioners on all insolvency appointments.

66. At present, debts owing to the government (incurred in the 12 months before liquidation) are preferential claims under s.265(1)(d) of the Companies Ordinance. We recommend that the preferential status afforded to these claims be abolished, and that the government rank with ordinary unsecured creditors for payment of their claims. We see no reason why the claims of the government should rank ahead of other creditors claims.

67. At present the sections dealing with the calculation of interest on creditors' claims are particularly complex for both practitioners and creditors to interpret. Additionally, there is case law affecting the circumstances in which interest is charged. We recommend that the statutory requirements for the calculation of interest on claims be centralised and simplified.

68. We recommend the creation of one "Insolvency Ordinance". At present, provisions applying to insolvency situations can be found in numerous Ordinances, rules and regulations. The creation of one piece of legislation for all provisions relating to insolvency procedures will ensure better understanding by the general public and assist practitioners.