COMPANY LAW REFORM

A. INTRODUCTION

The purpose of this letter is to set out the comments of The Hong Kong Association of Banks on the Companies (Amendment) Bill 2000 ("Bill") and the Report of the Law Reform Commission in respect of the winding-up provisions of the Companies Ordinance ("Report").

In broad terms, we welcome the Bill as legislative support for the intensive care and support operations that Authorised Institutions have adopted in dealing with distressed customers over the last decade or so. However, we consider that the Bill falls short of achieving a formal restructuring procedure where the interests of both creditors and debtors in Hong Kong are fairly balanced.

We are mindful that any new piece of legislation must incorporate checks and balances. In making the proposals contained in this letter we do so on the assumption that our proposals are not "cherry picked". To do so would detract from the balancing of competing interests upon which our analysis and recommendations in relation to the proposed legislation was predicated. We would also seek the opportunity to make further submissions once any subsequent drafts of the proposed legislation becomes available.

B. DRAFTING AND INTERPRETATION

1. Separate Ordinance

1.1 We consider that the proposals contained in the Bill relating to corporate rescue (sections 168U to 168ZZA) are cumbersome.

1.2 In order for the new procedure to work, regulations will need to be drafted. Consideration should be given, therefore, to requesting the Official Receiver or alternatively a suitably qualified committee to commence the necessary drafting work at an early stage so that the coming into effect of the new procedure is not delayed unnecessarily.

Recommendations

- *The new procedure should be contained in a separate Ordinance pending the introduction of a separate Insolvency Ordinance.*

- *The regulations should be drafted as soon as possible.*

C. IDENTIFICATION OF THE PROBLEM

2. Investigation and Reporting

2.1 While the Provisional Supervisor is given extensive powers of investigation there is no onus upon him to provide timely reports of his investigations to creditors. Accordingly, we would suggest that the Provisional Supervisor should be obliged to report on his findings on an interim basis if it is proposed that the duration of the Provisional Supervision will exceed the initial 30-day moratorium period. Thereafter regular reports should be submitted.

Recommendation

- *An interim report be produced by the Provisional Supervisor for all creditors within 6 weeks of his appointment and thereafter on a regular basis.*

3. Purpose of Provisional Supervision

3.1 Section 168Z of the Bill sets out the circumstances when a Provisional Supervisor may be appointed by the directors or shareholders of the company. This provision is intended to be a "check and balance' in favour of the creditors to avoid appointments for collateral purposes. We doubt in practice whether this will work as the preconditions for appointment are easily satisfied. In our experience insolvency practitioners will inevitably advise that an orderly realization of assets results in a greater return than on a winding up.

3.2 To facilitate the Provisional Supervisor discharging his duties, the directors should produce a statement of the company's circumstances

including its assets and liabilities.

Recommendation

- *The formation of the opinion that the company is insolvent or likely to become insolvent (see below) should be a sufficient precondition for appointment.*

- *A statement of the company's affairs verified by affidavit must be submitted to the Provisional Supervisor within 3 business days after appointment.*

4. Who can appoint

4.1 We see no reason to limit the power of appointment to the directors and shareholders, in our view the Major Creditor (see paragraph 10) should also be entitled to appoint.

Recommendation

- *The Major Creditor be given the power of appointment.*

D. MORATORIUM

5. Court Extension

5.1 Section 168ZD imposes a statutory moratorium on all creditors. The moratorium is initially only for 30 days but can be extended by court application. We do not believe that the court should play any general role in the extension of the moratorium (see paragraph 6). However, if a role for the court is to be retained, we make the following observations.

5.2 There appears to be no obligatory notice provisions to the creditors that the Provisional Supervisor has made an application to court for an extension. Furthermore it appears that a precondition to the court making an order extending the moratorium is that under section 168ZE(2)(c) the creditors as a whole will not be materially prejudiced.

Presumably the Provisional Supervisor will be obliged to give this opinion to the court in evidence. However, we do not think that a Provisional Supervisor will necessarily be able to make this determination in an impartial manner.

5.3 We also express concerns with the open ended nature of section 168ZE(3) effectively staying the effluxion of time while an application is heard. Presumably the court must make the determination within a 6-month period otherwise the court is without power to extend (section 168ZE(5)), however applications of this nature may be contentious and we are certainly concerned that the court process will not be able to expeditiously manage these applications.

Recommendation

- *The court should not be involved in the extension process. If this is not adopted then;*

- *Creditors should be given an automatic right of audience.*

- *The Provisional Supervisor should notify, in writing, all "substantial" creditors of his application for an extension and that application should, in addition, be advertised at least 5 working days before the hearing. In this regard "substantial" means a creditor holding more than 5% of the total liabilities of the company.*

- *Subsection (d) be added as follows:*

  (d) "no creditor or group of creditors controlling so much of the liabilities of the company that would make it unlikely for a proposal to be accepted has objected to the extension."

6. Creditor Extension

6.1 Under section 168ZS, it appears that creditors of the company are not intended to have any general role in determining when extensions should be granted unless the Provisional Supervisor forms the opinion that he cannot complete the proposal within six months of the Relevant

Date. We consider that this is not satisfactory. The Provisional Supervisor should be entitled to convene a general meeting of creditors within the initial 30-day period seeking the creditors' approval for an extension for whatever duration. Furthermore, we consider that the Ordinance should make it clear that the Provisional Supervisor is entitled to convene further creditors' meetings before any expiration of an extended moratorium period seeking a further extension.

Recommendation

- *The Provisional Supervisor should be able to seek an extension from the general body of creditors within the initial 30-day moratorium period (as to voting rights, see paragraph J).*

- *The Provisional Supervisor should be expressly able to convene further meetings of creditors to extend the moratorium.*

7. Set-Off

7.1 During the moratorium period, creditors will be prevented from exercising their rights of set-off except with the consent of the Provisional Supervisor or in the case of market contracts.

This provision is unacceptable. It is inconsistent with the Report where it was recommended that a debt can be set-off. Of greater concern is the position of a financier holding funds on account of a liability undertaken at the company's request (for example, a cash margin on a letter of credit). The legislation should not, in any manner, compromise the rights of the financier.

Recommendation

- *Rights of set-off, quasi security rights and any other right, such as the right to retain control of documents of title, bills of lading etc. must not be affected by the legislation.*

E. RIGHTS OF CREDITORS

8. Generally

8.1 This procedure ought only to be available to insolvent companies or companies likely to become insolvent. Insolvency should be defined as an inability to pay debts as and when they fall due. This is the definition contained in the comparable Australian legislation. It works well in practice and is easily understood.

8.2 We consider that the interests of the creditors should be expressed to be of paramount importance throughout the procedure. This seems logical given that, in reality, it is only the creditors who have the real interest in the assets of the insolvent company, not the shareholders.

Recommendation

- *Section 168Y(2)(a) be redrafted to apply only to insolvent companies.*

- *A clear definition of insolvency be included, and we suggest "a company is insolvent when it is unable to pay its debts as and when they fall due".*

- *Any proposal should compare the position of creditors with what they could expect from a liquidation.*

9. Early review of Appointment

9.1 To ensure the creditors' view the Provisional Supervisor as an independent appointment, we suggest that within a short period of time of appointment (say 7 business days) the Provisional Supervisor is to convene a meeting of creditors to either affirm his appointment or replace him. The meeting could also, if it so determined, form a committee of creditors.

Recommendation

- *Have a first creditors meeting to provide the creditors with the opportunity to replace the Provisional Supervisor with one of their*

choice.

10. Major Creditors

10.1 One of the principles behind the proposed legislation is that a "Major Creditor" can effectively veto the procedure on 3 working days' notice. We do not believe this period is long enough, particularly where the ultimate credit decision may need to be taken overseas.

10.2 We believe that the definition of Major Creditor encourages companies to become "over banked". This has been a factor contributing to financial distress and, in our experience, complicates the implementation of any rescue. In our view, consideration should be given to allowing the threshold to be calculated by reference to the claims of one or more secured creditors acting together. Alternatively, the one-third debt threshold needs to be deleted altogether or significantly lowered in order to reduce the tendency for companies to be "over banked".

10.3 The Major Creditor should be a holder of a charge over the whole or substantially the whole of the company's property. In the usual case the business assets would be subject to a floating charge and the holder of such charge should be the Major Creditor.

10.4 As a general point, secured creditors should not have their rights affected without their consent.

Recommendation

- *The holders (in aggregate) of a floating charge(s) over the whole or substantially the whole of the company's business assets and undertaking should be able to veto the procedure.*

- *No proposal or modification which affects the right of a secured creditor of the company to enforce his security shall be approved except with the concurrence of the creditor concerned.*

11. Calculation of Liabilities and Claims

11.1 It is important that the mechanism by which all "liabilities" are calculated is set out clearly in the Ordinance itself or in the regulations. In particular, issues that have to be addressed are the manner in which contingent creditors are dealt with and double proofs of debt.

11.2 We consider that for the purpose of calculation of liabilities, related or associated debt (as that term is defined in the UK Insolvency Act) should be excluded unless it is controlled by an independent third party such as a liquidator.

11.3 Furthermore, in determining these liabilities, are the total liabilities of the company calculated on a net or gross basis? Moreover, what is to happen if the charge is only partly valid? (for example, because of the operation of section 267 of the Companies Ordinance (avoidance of floating charges) or section 168ZQ(4)); is the unsecured portion of the debt ignored for the purposes of calculating the one third percentage? We believe that this is not what is intended but would suggest that these issues are clarified.

Recommendation

- *The basis upon which liabilities are assessed and quantified needs to be expressly provided for.*

- *Related or Associated Debt should be excluded for the purpose of determining the amount of company debt .*

- *A number of drafting/technical issues with regard to the operation of section 168ZQ(4) need to be clarified.*

12. Voidable Security

12.1 Whilst the language used in section 168ZQ(4) is similar to section 267 of the Companies Ordinance, we would suggest that the definition of consideration for the charge be extended to include "goods and/or services supplied and other good and valuable consideration". These

benefits may enable the business of the company to continue. As a matter of principle, we do not believe that it is right that those creditors be prejudiced by avoiding their security.

Recommendation

- *The definition of consideration for the charge should be extended to include other valuable consideration.*

13. Directors' Claims and Employees' Rights

13.1 Provisional Supervision cannot take place unless all the company's liabilities to its employees and former employees are either satisfied or provided for in full. Where the company has significant arrears to employees and/or a number of highly paid staff, this requirement will greatly restrict the availability and usefulness of the procedure. Realistically, the only source of funding is likely to be some or all the company's financial creditors.

13.2 Unless financial creditors are given sufficient assurance with regard to the availability of security they will not provide funds to satisfy claims of employees in priority to their own lending. More fundamentally, the majority of Hong Kong companies continue to be dominated by a number of key individuals. In numerous cases, those individuals are also directors (and major shareholders) of the companies concerned. In many instances, those directors will be seen as having caused the financial difficulties with which financial creditors and other creditors are faced. In such circumstances, it is wholly unacceptable to propose that the directors should be repaid while other creditors are not.

Recommendation

- *Claims of employees should not have any priority from fixed charged assets.*

- *Claims of employees being met should not be a precondition to Provisional Supervision.*

- *The claims of directors and their associates (as defined in the Insolvency Act 1986) should be generally postponed.*

14. Super Priority Lending

14.1 Section 168ZP of the Bill provides that anyone lending minimum operating capital to a company shall be repaid in priority to other creditors (other than fixed charge holders). This provision is intended to make it easier for a company to generate the working capital it needs to effect a rescue. In our view, regardless of whether the quantum is greater than or equal to the minimum operating capital required, all additional lending by third party creditors (financial or otherwise) during a moratorium should have priority subject only to existing fixed charge security.

Recommendation

- *All new money lending should obtain a priority subject only to existing fixed charge security.*

15. Power to Deal with Charged Property

15.1 The Bill appears to be drafted on the basis that valid existing security (fixed or floating) will be recognised by the Provisional Supervisor. However, there are no provisions in the Bill that permit the Provisional Supervisor to override the rights of the holder of the security for the purposes of achieving a successful rescue such a provision may be necessary where a Major Creditor has not exercised their right of veto and the proposal completely protects their interest. We would support such provisions provided that in the event that the Provisional Supervisor proposed to override the rights of the holder of security, in the absence of their consent, he would need to obtain court approval. As this affects the proprietary rights of secured creditors, we would envisage that a high standard of proof would be required before the court would intervene. In the case of floating security he would need to deal with the proceeds as he would have had to in respect of the original property. In addition it would be expected that the net proceeds of the security are applied towards discharging the claims of

the relevant holder of the security and/or equivalent security of the same value is substituted for the original charged property. Clearly, there is a risk that such charged property may be sold at a time which is not favourable to the security holder. In the circumstances, in making any such application, the Provisional Supervisor will need to be mindful to protect the interests of the security holder.

Recommendation

- *The Provisional Supervisor should be given limited powers to deal with charged assets.*

F. ANTECEDENT TRANSACTIONS

16. Swelling The Restructuring Pot

16.1. The assets ultimately available to distribution to creditors in any rescue do not only concern its trading or business assets. Occasionally, there may be other assets or avenues for recovery such as, the proceeds of litigation and/or claims which arise solely on insolvency such as those under section 266A (Unfair Preferences), section 271(Misfeasance), section 275 (Fraudulent Trading), section 182 (Voidable Dispositions), section 183 (Avoidance of Attachments) of the Companies Ordinance, section 60 of the Conveyancing and Property Ordinance (Voidable Dispositions) and, potentially, the recoveries of successful actions for Insolvent Trading.

16.2. As drawn, the Bill does not require the Provisional Supervisor or Supervisor to specifically report upon these claims to creditors. We suggest (as under Insolvency Rule 1.3 of the Insolvency Rules 1986) that any proposal for the rescue of the company should include certain fundamental matters which must be addressed in each case by the Provisional Supervisor in order to ensure that creditors can properly assess their respective positions and evaluate the assets of the company.

Recommendation

- *The Provisional Supervisor should be obliged to report on potential*

claims which may increase the assets available for distribution. In doing so he should be specifically required to provide a liquidation analysis taking into account the assets of the company and the likelihood of recoveries.

G. PROVISIONAL SUPERVISORS

17. Preserving and Collecting in the Assets of the Company

17.1 The Bill provides that one of the duties of the Provisional Supervisor is that *"as soon as practicable"* he must *"take into custody"* all of the property to which the company is or *"appears to be entitled"*. However, there are no provisions similar to section 211 (delivery up) and section 221 (examination) of the Companies Ordinance to assist the Provisional Supervisor with an uncooperative party. We believe these legal powers should be vested in the Provisional Supervisor to enable him to collect in the assets of the company.

Recommendation

- *The Provisional Supervisor be given powers of investigation similar to those of a liquidator.*

17.2 We consider that creditors' committees are important and have been an integral part of the administration of insolvency cases. We therefore consider that creditors' committees should be formed to assist the Provisional Supervisor and any Supervisor to an approved Voluntary Arrangement.

Recommendation

- *The legislation should reflect the desirability of the formation of committees of creditors.*

18. Qualifications and other Requirements

18.1 The persons qualified to act as Provisional Supervisors are set out in section 168X and as Supervisors under section 168ZW. The Bill

provides that both solicitors and accountants may take such appointments. These professions are governed by legislation in Hong Kong and are, in addition, subject to rules of professional conduct. We are concerned that, in theory, parties which do not have the same level of regulation may become eligible to hold office. It is essential that measures are introduced to ensure a high standard of competence, as well as integrity, in the persons who are eligible for office. This should be achieved by requiring all candidates for appointment to be licensed.

18.2 We note that section 168X(b) and section 168ZW(1)(b) provide that the regulations will require the provision of *"security"*. We agree that such security is essential and (bearing in mind that solicitors and accountants are obliged to provide professional indemnity insurance), we believe that adequate professional insurance should also become a mandatory requirement. The regulations should require such insurance to cover all types of fraud, dishonesty and professional negligence to a level commensurate with the job undertaken.

Recommendation

- *All Provisional Supervisors should be suitably qualified and experienced professionals with adequate insurance and bonding obligations.*

19. Powers

19.1. We refer to our comments above with regard to the preservation and collection of assets. We also refer to schedule 1 of the Insolvency Act 1986. Provided our comments in respect of the qualifications and licensing of practitioners are accepted, we would support granting the powers contained in the Insolvency Act 1986 to the Provisional Supervisor/Supervisor. We believe these powers are more likely to achieve the survival of a business as a going concern.

Recommendation

- *The Provisional Supervisor should have comprehensive powers.*

20. Remuneration Priority

20.1 We do not consider that the Provisional Supervisor should be granted priority for his fees and expenses from fixed charged assets.

Recommendation

- *The Provisional Supervisor's costs and expenses do not take priority over a fixed charge.*

H. ACHIEVING THE RESCUE

21. The Exit Solution

21.1 Subject to our comments at paragraph 15.1, we do not think that any proposal put to creditors should be able to be approved by the requisite majority of votes that will have the effect of prejudicing a secured creditors rights under their security, or force them to take less than what would otherwise be available on the realization of their security. In the UK, the creditors do not have the power to approve any proposal that affects the right of the secured creditor to enforce their security without their consent (Insolvency Act 1986 section 4(3)). This position should be reflected in this legislation.

21.2 We agree that the approval of any proposal by the creditors should be binding on the shareholders of the company. However, we are concerned as to how this will apply in the case of companies which are publicly traded.

21.3 In particular, we are concerned about the attitude/response of the Stock Exchange of Hong Kong Limited ("Exchange") and the Securities and Futures Commission ("SFC") to (a) Provisional Supervision itself and (b) the approval of any proposal by the creditors. We believe that these issues need to be contained in a joint announcement of the Exchange and the SFC. In addition, we would contend that the trading of shares whilst a company is in Provisional Supervision is not conducive to achieving a restructuring and we would recommend a statutory suspension of share trading during the procedure.

21.4 The Bill does not clarify whether the Provisional Supervisor can allot shares pursuant to a mandate give by the company's shareholders prior to his appointment or whether the terms of any proposal can modify or alter existing shareholdings.

Recommendation

- *Subject to our comments at paragraph 15.1, secured creditors cannot, without their agreement, be bound by the terms of a proposal*

- *The introduction of a shareholders' trading moratorium during the procedure.*

- *That the Exchange and SFC produce a joint announcement/practice note on the implementation of the procedure in respect of listed company.*

I. OTHER MATTERS

22. Challenge to Decisions

22.1 Aggrieved creditors and shareholders should be able to challenge any decision of the Provisional Supervisor (including the calculation of liabilities and admissions of proofs of debt) and have a right of recourse in the event that they consider that any proposal passed by the creditors is unfairly prejudicial or discriminatory.

Recommendation

- *The introduction of an effective procedure to challenge decisions before the court in the event of a "material irregularity" or in the event of "material prejudice".*

- *Courts should have a overall supervisory role on the application of any aggrieved creditor or shareholder.*

J. VOTING

23. As a consequence of the draft legislation and the recommendations contained in this letter, there are a number of critical times that creditors may wish to exercise rights conferred upon them. They may want to appoint or veto the appointment of a Provisional Supervisor; to replace the Provisional Supervisor at the first meeting of creditors; to extend the moratorium or to pass the proposal. We do not consider that creditors should have to value their security for the purposes of voting but may vote the full amount of their debt. This is consistent with the Australian position. Accordingly, if a secured creditor votes in favour of a proposal, they become bound by its terms regardless of their security position. We consider that the voting should be as follows:-

Appoint or veto appointment:	Major Creditor (paragraph 10)
Replace Provisional Supervisor (paragraph 9):	Majority of creditors in value attending and voting in person or by proxy
Extend the Moratorium (paragraphs 5 and 6):	Majority of creditors in value attending and voting in person or by proxy
Proposal:	Majority of creditors in number and two thirds in value attending and voting in person or by proxy

Recommendation

- *Recognizing that the interests of the creditors are of paramount importance in a Provisional Supervision these comments are drawn up to protect these interests and the voting is likewise tailored to the individual event.*