THE LAW SOCIETY OF HONG KONG 香港律師會

Comments on Consultation Paper on "Review of Corporate Rescue Procedure Legislative Proposals"

The Law Society has reviewed the Consultation Paper and has the following comments:

Question 1
Do you agree with the proposed procedural changes relating to initiation of provisional supervision in paragraphs 2.4 to 2.6 above? If not, please provide reasons and suggest alternatives.

Answer
We agree with the proposed procedural changes relating to initiation of provisional supervision. We recommend the notice of appointment and requisite documents should be filed to the Registrar of Companies within 14 days of the appointment of the provisional supervisor as this will enhance transparency and will be similar to the procedures under Section 228A of the Companies Ordinance. We do not consider it necessary to file these documents with the Official Receiver and/or the High Court as neither have any involvement at this stage. Obviously, the company itself should call a Board meeting to formalise the appointment of the provisional supervisor together with all statutory requirements such as the preparation of the company statutory form which should be delivered to the Registrar of Companies duly signed by a director of the company.

Question 2
Do you see any need for other changes to the initiation of provisional supervision, including who may initiate the procedure? If so, please elaborate on the suggested changes and reasons.

Answer
We note the commentary in relation to creditors and whether any creditor could initiate the process of provisional supervision. As a creditor is not an officer of the company, he or she may not be familiar with company's operations or its financial position and may not want to be entangled with the potential liability involved in making such appointment. We therefore consider it inappropriate to enable creditors to initiate the procedures to appoint a provisional supervisor, unless such member is also a director of the company.

We agree there is no need to introduce any changes to the initiation procedures for the appointment of a provisional supervisor, including who may initiate the procedure.

The Consultation Paper notes provisional supervision under the 2001 Bill could be initiated by: the company or its directors or provisional liquidators or liquidators appointing a provisional supervisor. The Law Society would like to FSTB to clarify the meaning of "***the company***", and upon receipt of the same reserve our right to make further submission on this matter.

Question 3

Do you agree that the notice of appointment of provisional supervisor should be published in the local newspapers on the same day as the date on which the last document is filed with the Registrar of Companies? If you prefer additional or alternative means of publishing the notice of appointment, please describe and explain.

Answer

From a practical view we submit that notices to creditors should be sent out as soon as practicable but in any case it should be sent out within 7 days after the appointment date. Similarly, the notice of appointment should be advertised, gazetted and sent to the Registrar of Companies within 14 days (as discussed above) of the appointment of a provisional supervisor. We submit it is unnecessary to publish the notice in the newspaper on the same day as the date on which the last document is filed with the Registrar as this will create an unnecessary administrative burden on the provisional supervisor.

Question 4

Do you support an initial moratorium period of 45 days? If not, please suggest alternatives and explain.

Answer

The Law Society recommends the initial period of the moratorium should be 90 days as the provisional supervisor needs a realistic period to get up to speed, and this is particularly so with larger administrations. We do not consider the proposal of additional days to be prejudicial, but in terms of reality, this extended period will be very important for the provisional supervisor.

Question 5

Do you support the proposal to allow for extension of the moratorium up to a maximum period of six months from the commencement of provisional supervision, subject to approval by the creditors at a meeting of creditors? If not, please explain and suggest alternatives.

Answer

We support this, but we do not think the possibility of Court involvement should be excluded. We understand the ideal is to limit Court involvement; however, it does make sense to have the Court option available as a last resort. We therefore suggest including this extension option in the alternative, i.e. with the approval of creditors, or by application to the Court. If any such application is to be made to the Court clearly an explanation would have to be given as to why a creditors' meeting was not held or agreement reached. In reality there could be any number of circumstances which might make it difficult to have a meeting of creditors within the deadline, let alone have them agree an extension. The

involvement of the Court would in fact be consistent with the procedures in other common law jurisdictions.

Question 6
Do you agree with the proposal to allow for extension of the moratorium beyond six months only upon court approval? If not, please explain.

Answer
We agree the moratorium should be extended beyond six months or longer if the court so orders.

Question 7
If your answer to Q6 is yes, do you agree that any court extension should not exceed a maximum of 12 months from the commencement of provisional supervision? If not, please explain and suggest alternatives.

Answer
The Law Society notes that if an application has been made to the Court there is no need to impose arbitrary time limits. It is not possible for anyone to say how long a particular administration will run, and given that the extension can only be with Court sanction, that is a sufficient check. Again, this is consistent with the procedures in Singapore and England and Wales.

Question 8
Does the list of contracts and agreements which should be exempted from the moratorium, as set out at Appendix, need to be revised? If so, please suggest and explain.

Answer
We have no revisions.

Question 9
Which of the above three options (namely, the 2003 Proposal, Alternative A or Alternative B) would you prefer? Please explain. If you have any suggestion to refine any of the above three options, please describe and explain. If you prefer another alternative, please describe and explain.

Answer
Of the three options, namely, the 2003 Proposal, Alternative A or Alternative B, Alternative B is by far the best.

In the context of corporate rescue, time is of the essence. The 2003 Proposal required a disproportionate amount of time and effort to be put into raising cash to secure the claims of employees by depositing the cash in a segregated trust account. By definition, a company in need of restructuring is short of cash and there may be far greater commercial priorities on

the company's cash flow (e.g. ensuring continued crucial supplies) than securing employees' claims.

It is also to be stressed that the class of employees is not limited to the old-fashioned term the "workers". It extends also to management employees. Even though the 2003 Proposal contained a financial cap on employee claims, it is unlikely banks or creditors will be particularly sympathetic to scarce company funds being segregated for the benefit of, for example, the managing director and the finance director who are the people who prima facie bear responsibility for the company being in the financial straits that it is.

Alternative A is a recipe for disaster. It gives to employees, whether individually or collectively, a powerful blackmail weapon: "pay my claim or I will torpedo the corporate restructuring". The whole purpose of a moratorium in a corporate restructure is to *stay all claims* against the company whilst a restructuring proposal is worked out.

If Alternative A is adopted, we foresee the Legal Aid Department, on behalf of "workers", routinely presenting or threatening to present a winding-up petition simply to ensure better treatment for employees. Given such a petition can represent the totality of employee claims, we face returning to the original problem of the 2001 Bill namely why should employee claims be paid in full in the context of a corporate restructuring when other creditors are being asked to forego prosecuting their claims?

In many restructurings, it is often desirable to remove one or more of existing senior management. Such senior management are also employees and Alternative A would allow them to present a winding-up petition which might serve to frustrate a corporate restructuring. It is not difficult to envisage circumstances in which a disaffected managing or finance director might seek to sabotage a corporate restructuring by presenting a winding-up petition based upon his own claim for unpaid wages.

Alternative B has the considerable merit that employee claims are treated in a corporate restructuring similarly to the way they will be treated in a liquidation. Employee claims cannot be disregarded because it will be incumbent upon the provisional supervisor to put in effect proposals to settle "employees' protected debts". However, as actual payment need not take place until after the moratorium, the company in restructuring will have the opportunity to raise further funds (such funds likely to be priority in repayment and therefore more readily available from banks) to settle "employees' protected debts".

There may be consequential legislative and administrative changes to extend the ambit of the Protection of Wages on Insolvency Fund but this is a small price to pay for a sensible proposal which gives protection to employees whilst at the same time not frustrating a possible restructuring of the company.

Question 10
Independent of which of the above options is adopted, what are your views on the treatment of outstanding employers' MPF scheme contributions[41]?

Answer
We see no basis upon which outstanding employers MPF scheme contributions should be treated differently in provisional supervision than in liquidation. As such amounts constitute

unsecured claims in a liquidation, they should similarly be treated and given no special protection in provisional supervision.

Question 11
Do you agree with the proposal that solicitors holding a practising certificate issued under the Legal Practitioners Ordinance (Cap 159) and certified public accountants registered in accordance with the Professional Accountants Ordinance (Cap 50) may take up appointment as provisional supervisors?

Answer
We agree. Connected with this response is the answer to Question 13 where we are in favour of giving the creditors the right to replace a provisional supervisor chosen by the company or its directors etc at the first meeting of creditors.

Question 12
Do you think that other persons without the above qualifications could also be appointed as provisional supervisors on a case-by-case basis? If so, should such an appointment be made by the OR or the court? Please elaborate, in particular on the appeal channel in case of aggrieved applicants and on the associated investigatory and disciplinary regime in case of complaints against appointed persons.

Answer
In principle, we are in agreement with the proposal that other persons lacking the qualifications referred to in Question 11 should also be considered eligible for appointment as a provisional supervisor on a case-by-case basis ("Non-qualified Appointees"). Paragraph 5.8 of the Consultation Paper recognises there are a number of restructuring professionals/company doctors who may not possess the necessary qualification requirements referred to in paragraph 5.6 but who nevertheless have suitable skills to act effectively as provisional supervisors. We see no reason why such appointments could not be made on a case-by-case basis by the Official Receiver or indeed the Court. However, bearing in mind the Corporate Rescue Proposals envisage minimal Court involvement, our preference would be for the former. The Official Receiver might consider stipulating conditions to such an appointment of Non-qualified Appointees in order to safeguard creditors' interests in the form of a provision of a bond/bank guarantee. The Official Receiver already has powers under Rules 47 and 48 of the Companies (Winding-Up) Rules to direct a special manager or liquidator to give security in such a manner as the Official Receiver may determine, including the nature and amount of such security. The additional safeguard is that if the appointee does not meet with the approval of the creditors at their first meeting, the individual can be replaced.

The second limb of Question 12 relates to the possibility of appeal channels in case of aggrieved applicants and on the associated investigatory and disciplinary regime in case of complaints against appointed persons. In considering mechanisms for appeal channels, we are mindful of the concerns expressed in paragraph 5.5 of the Consultation Paper in relation to establishing a panel system which will require considerable time and resources and setting out criteria and screening processes for Non-qualified Appointees as well as the appeal and disqualification procedures.

Paragraph 5.5 went on to add that the criteria for appointment of the panel would also be open to debate and if it were too strict, there would be concerns about the dangers of a "closed shop" and high fees being charged by provisional supervisors. In this regard, to avoid these pitfalls we suggest that the question of selection/screening by the Official Receiver should be subject to his discretion which is exercised based on general parameters as to the type of skills the appointee should possess to be eligible for appointment as a provisional supervisor.

In relation to that aspect of the question relating to the investigatory and disciplinary regime in case of complaints against appointed persons, this is a function which could also be carried out by the Official Receiver. If the Official Receiver were satisfied that a Non-qualified Appointee (as the provisional supervisor) was culpable of misfeasance resulting in loss or damage to the company and hence the creditors' interests, such loss or damage could be compensated by:

(a) resorting to any bond/bank guarantee provided by the provisional supervisor;

(b) precluding the provisional supervisor from seeking indemnification for such liability against the assets of the company; and/or

(c) disqualifying the Non-qualified Appointee to act as provisional supervisor for a pre-determined period in the future.

Given the ramifications of such draconian action, there should be a right of appeal to the Court in favour of the appointed person in relation to such disciplinary sanctions.

Question 13
Do you agree with giving creditors the choice to replace the provisional supervisor appointed by the company or its directors or the provisional liquidators or liquidators of the company and approve the remuneration of the provisional supervisor at the first meeting of creditors to be held within 10 working days from the commencement of provisional supervision? If not, please elaborate on the reasons and suggest alternatives.

Answer
We agree. The ability of a majority of the creditors in value to replace a provisional supervisor with a nominee of their choice at the first meeting of the creditors, would be consistent with the same approach and powers which the creditors have in a winding-up to replace a provisional liquidator with a nominee of their choice. This gives recognition to the precedence given to the views of creditors as major stakeholders in the outcome of the provisional supervision.

Question 14
Do you support imposing personal liability on provisional supervisors as proposed in paragraphs 5.14 to 5.17 above? If not, please suggest alternatives which would effectively address the issues set out under paragraphs 5.16(a) to (c).

Answer

We refer to our comments to Question 9 above in relation to Alternative B and in this regard, consider there is a good interface with the recommendations made in paragraph 5.14 of the Consultation Paper which affords the provisional supervisor a grace period of 16 working days after the commencement of the provisional supervision to determine whether to accept pre-existing employment contracts. In fact, we recommend extending this period to 30 days to afford a reasonable period of time for the appointee to conduct due diligence in relation to the current financial position of the company particularly in the context of prospective personal liability the provisional supervisor will incur if the proposals in paragraph 5.17 are adopted.

We are mindful of the comments made in paragraph 5.14 that imposing personal liability may deter experienced professionals from taking up an appointment as a provisional supervisor. The grace period is an important facet of the proposals as it will afford the provisional supervisor a reasonable period of time in which to make an informed decision not only as to the current financial position of the company and its unencumbered assets, but also the prospect of raising additional funding in order to allow the objectives of the provisional supervision to be met. In this regard, the proposal that any additional funding obtained post-appointment would be accorded priority over the company's pre-existing indebtedness will help further the goals of achieving a successful voluntary arrangement in those cases where there is a viable ongoing business.

Whilst the provisional supervisor will be deemed an agent of the company and will thus have an indemnity against the assets of the company, the concern we have is in relation to those not uncommon situations where the distressed company's assets are subject to a fixed and/or floating charge over a substantial part or the whole of the undertaking. For example, in the case of a large manufacturing enterprise, a provisional supervisor in accepting pre-existing employment contracts could be taking on significant personal liabilities which might not be fully reimbursable from the unencumbered assets of the company. No doubt, in such a scenario an appointee would not accept pre-existing employment contracts and taking on new credit from suppliers without additional funding support from the creditors.

It may well be that in practice, provisional supervisors will be reluctant to assume personal liability without the additional safeguard of a direct indemnity from a major secured creditor in the event there is a shortfall in the value of unencumbered assets to meet the costs and expenses of the provisional supervision and the personal liabilities imposed upon the provisional supervisor pursuant to accepting and carrying out the appointment.

To draw upon an analogy as to the position of a liquidator, it had been thought that the costs and expenses of a winding-up were payable out of the assets comprised in the crystallised floating charge on the strength of the English Court of Appeal decision in *Re Barleycorn Enterprises Limited* [1970] Ch 465 where it was held that the expenses of winding-up were payable out of the assets subject to the floating charge in priority to both preferential creditors and the claims of the charge-holder. However, the House of Lords overruled *Re Barleycorn Enterprises Limited* in the case of *Buchler v Talbot, Re Leyland Daf Limited* [2004] 2 AC 298 in holding that none of the costs and expenses of the winding-up were payable out of the assets subject to the floating charge until the whole of the principal and interest had been paid of the charge-holder. The House of Lords' decision in *Re Leyland Daf Limited* has been followed in Hong Kong in *Re Good Success Catering Group Limited;* [2007] 1 HKLRD 453. The assets the subject of a floating charge were recognised as

comprising a distinct fund to the company's unsecured/free assets, each fund bears its own costs of administration and neither fund was required to bear the costs of administering the other. The only statutory exceptions to this rule are the preferential payments payable pursuant to Sections 79 (receivership) and 265(3B) (liquidation) of the Companies Ordinance, which have priority over the claims of holders of debentures under any charge **created as a floating charge by the company** and are paid out of any property comprised in or subject to the charge under circumstances where the unsecured assets of the company are insufficient to meet the preferential payments. [NB: In 1987, amendments were made to this provision to ensure that the preferential payments under sub-Section 265(1) were paid out in priority to the charge-holder from the assets subject to a floating charge notwithstanding the automatic crystallisation of the charge as at the time of commencement of the winding-up. Prior to the amendment, if the charge had crystallised by the time of insolvency so as to become a fixed charge (as it usually would have by virtue of an automatic crystallisation clause), preferential creditors were denied their priority, hence the reason for the amendment in 1987.]

We note in the Consultation Paper the rationale for imposing personal liability on provisional supervisors. However, our observations in relation to those purposes as set out in paragraphs (a)-(c) of paragraph 5.16 are as follows:

(a) Whilst it is important to encourage provisional supervisors to perform a rigorous due diligence exercise before accepting appointment, the efficacy of that exercise may only be as reliable as the financial information and statement of affairs provided by the directors of the company. The aim would be to strike a balance so that the provisional supervisor is not distracted in the course of his appointment in focusing on his own personal liability as opposed to achieving the objectives of the provisional supervision. Hence, in practice, provisional supervisors might adopt a "belt and braces" approach by seeking additional indemnities from the major secured creditor.

(b) The reality is that in a majority of cases, trade creditors will insist upon cash on delivery or secured payment terms if they are to continue to provide goods and services once the company has entered into provisional supervision, which in turn is likely to be reliant on additional funding forthcoming.

(c) This is unlikely to occur if the recommendations referred to herein are adopted. Indeed, an important facet of the proposals is the intended right to be given to a major secured creditor to decide within 3 working days whether or not to participate in a provisional supervision. As paragraph 7.3 of Chapter 7 refers, if a major secured creditor objects, the provisional supervision would cease. This power of veto will give a major secured creditor considerable leverage to influence the appointment of the provisional supervisor.

Question 15
Do you support the introduction of insolvent trading provisions? In case you do not, please explain and suggest alternatives to (a) encourage timely initiation of provisional supervision; and (b) deter irresponsible depletion of the company's assets.

Answer
We fully support the introduction of insolvent trading provisions.

Question 16
Do you agree with the proposed revised formulation of "insolvent trading"? If not, please suggest alternatives.

Answer
We agree with the proposed adjustments to the "insolvent trading" provisions, namely "excluding senior management from being liable under insolvent trading and modifying the standard in establishing liability.

We note the difficulties in defining "insolvent trading". "Trading" can be relatively speaking easier to define, unlike "insolvent" because it involves different perspective of assets and liabilities. For example, if it were defined as "total assets < total liabilities", such a definition would create huge problems as many Hong Kong companies will fall into this category. There are also technical reasons as some of the company's intangible assets, such as customers' relationship, will not be quantified or included in its financial statements. In reality, when facing a financial crisis such as the recent economic downturn, many companies will suffer from "short-term" insolvency as "fair value" of its assets decrease drastically. The business sector objected strongly to the proposal to introduce "personal liability for insolvent trading" because directors or senior management could easily be caught by such a definition.

We agree senior management should be excluded from liability under insolvent trading as this will encourage them to "assist" directors to rescue the company. We also agree that the time-frame for initiation of provisional supervision is adequate under the new proposal.

However we ask that a clearer definition of "insolvent trading" be provided in order to avoid any ambiguity in the proposed legislation.

Question 17
Do you agree with the way that "major secured creditors" was defined in the 2001 Bill? If you think any changes are needed, please elaborate and explain.

Answer
We agree with the proposed definition of "major secured creditors", although we envisage there could be arguments as to what would constitute a charge over "substantially the whole of the company's property". As already pointed out in the Consultation Paper, if a percentage is ascribed to the meaning of "substantially" this could cause significant problems. If the proposed definition is adopted this may result in a judicial interpretation of "substantially".

Question 18
Do you support the proposal to largely follow the 2001 Bill approach with respect to protection of "major secured creditors" and other secured creditors' rights? If you think any changes are needed, please elaborate and explain.

Answer
We support the proposal that the protection afforded to the secured creditors, whether major or not, is to follow the approach in the 2001 Bill and that they will be bound by the moratorium. However, if they opt out of the voluntary arrangement, they can rely on their own security after the expiration of the moratorium.

Question 19
What are your views on retaining or removing the "headcount test" in the voting at meetings of creditors (i.e. requirement (a) stated in paragraphs 8.1 and 8.2 above) for resolutions to be passed at meetings of creditors?

Answer
We support the retention of the "headcount test". In the Consultation Paper, it was said that the "headcount test" could have the potential of distorting the voting at the creditors' meeting. We do not agree as this test is only one of the requirements for a resolution to be passed. The other 2 requirements would ensure that creditors with a substantial provable debt would be able to have views reflected in any resolution.

The Law Society of Hong Kong
Insolvency Law Committee
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