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CORPORATE RESCUE: HONG KONG DEVELOPMENTS ¹

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The terms "rescue culture" and "corporate rescue" have been commonly used in the commercial world for many years. In the 1970s, the Americans introduced their celebrated (or notorious) chapter 11 procedure. In the 1980s, the United Kingdom put in place its administration and company voluntary arrangement regimes. And in the early 1990s, Australia enacted its own corporate voluntary administration procedure. In the mid-1990s, the Law Reform Commission ("LRC") in Hong Kong began considering corporate rescue and, in due course, recommended a regime – to be called "provisional supervision" – with marked similarities to the corporate voluntary administration in Australia.

With the onset of the Asian financial crisis, and seemingly ever-rising levels of insolvency in Hong Kong, corporate rescue has remained a high-profile topic. Until now, re-structurings in Hong Kong have been conducted wholly outside of a modern statutory rescue framework. But, finally, it seems Hong Kong is close to putting its own corporate rescue regime on the statute books, following the gazetting in May 2001 of the Companies (Corporate Rescue) Bill 2001. Yet, even now in early 2002, some doubts remain as to the future of the Bill.

Introduction

At present, the only statutory mechanism that is available in Hong Kong under which a financially distressed company can re-structure is a scheme of arrangement pursuant to section 166 of the Companies Ordinance (a replica of the UK scheme of arrangement procedure). There have always been complaints about the section 166 scheme of arrangement when used in relation to a corporate rescue (for which it was not specifically designed), including that schemes of arrangement tend to be complex, are highly technical, require too many court hearings and, unless conducted when a company is in provisional liquidation, do not benefit from a moratorium.

When, in 1996, the LRC put forward its plans for the new provisional supervision regime, it was intended that provisional supervision would be a streamlined procedure, with minimal court involvement but with the crucial advantage of a moratorium. A company, without going to court, could appoint a suitably qualified professional – normally an accountant with extensive insolvency experience – who would take over the management of the company and whose task it would be to ascertain whether a rescue plan was feasible. If so, the rescue proposal would in due course be put to the creditors for approval. Approval would be obtained by a vote of two-thirds in value of the creditors present and voting in one single class. (It may be noted that three-quarters approval is required to approve a scheme of arrangement and creditors will often be divided into several classes.) To facilitate a provisional supervisor's attempts to rescue a company, the LRC also recommended the introduction of super-priority funding: so that where funds were provided as working capital by a lender *after* the commencement of the provisional supervision, such debt would be given priority over all other debts (except a fixed charge).

I. The Old Bill

The recommendations of the LRC were first put forward in Bill form (the "old Bill") in January 2000, as part of the Companies (Amendment) Bill 2000. The old Bill, however, came under heavy criticism for a number of its proposals. The one issue that attracted the most public debate was the way in which the old Bill dealt with wage and other claims

owed to a company's workers. It proposed that a company would either have to pay, in full, all wages and other entitlements owing to the workers, or set up a trust account with sufficient funds at a bank, *before* the company could go into provisional supervision. This was not, however, what the LRC had initially proposed. The LRC had hoped that the Protection of Wages on Insolvency Fund – a very rough equivalent of the UK's National Insurance Fund – would be extended to cover provisional supervision (currently it only applies where a company goes into insolvent liquidation). The obvious question in relation to the old Bill was how a financially distressed company might raise the cash necessary to pay (in advance and in full) all outstanding wages, severance payments, long-service payments etc. Not surprisingly, many commentators saw the requirement of having to pay the workers in full as an enormous limitation upon the utility of provisional supervision. Unfortunately, however, the new Bill (discussed below) did not improve upon this position.

Another criticism of the old Bill, of particular concern to secured lenders, was that the old Bill did not prevent the meeting of creditors from approving a proposal that cut down the rights of a secured creditor. In other words, it was contemplated that a secured creditor (even though fully secured) could be forced to take a haircut along with the rest of the (unsecured) creditors.

II. The New Bill

The Companies (Corporate Rescue) Bill 2001 ("the new Bill") has cured this last-mentioned defect. Under the new Bill (see section 23(1)) the rights of a secured creditor cannot be cut down without the consent in writing of the creditor concerned.⁴

Unfortunately, however, the approach to workers' wages was not improved under the new Bill. Under section 8, and the Second Schedule, no provisional supervision may commence until the company has paid off in full (or set up a trust account with a licensed bank containing sufficient funds to pay off in full): (a) all wage claims owed to its employees; and (b) all entitlements arising under the Employment Ordinance (e.g. severance payments) owed to its "former employees." Moreover, "former employees" is widely defined. It includes not just workers who have already been laid off, but also workers whose employment *will* be terminated on or after the commencement of the provisional supervision. For example, if a company intends to go into provisional supervision and then lay off half its workers as part of a restructuring, the company will have to calculate and pay, in advance, not only the wages it owes to all its employees but also any severance payments that will become due once the lay-offs are put into effect. There can be no doubt but that the treatment of workers' entitlements under the new Bill would act as a major obstacle to many companies that might otherwise seek to go into provisional supervision. This fact has been repeatedly pointed out to the Government.

Finally, it appears that a possible compromise is in the offing. The Bills Committee of the Legislative Council has (as of December 2001) suspended its deliberations on the new Bill pending further consultations. It is now being proposed that instead of a company having to pay off its workers in full in advance (or to set up a trust account), a limit or cap will be put on the amount that will have to be set aside by the company before it can go into provisional supervision. This limit would be calculated by reference to the amounts currently payable by the Protection of Wages on Insolvency Fund where a company goes into insolvent liquidation.⁵

III. Provisional Supervision and the Secured Lender

Leaving to one side the question of the treatment of workers' wages, the number of companies that will make use of provisional supervision in the future depends greatly upon the attitude of the banks. Where a bank has security, typically a floating charge, over substantially all the company's assets, the new Bill gives a veto power to the bank over the continuation of the provisional supervision. Under the new Bill a major secured creditor will have only 4–7 working days (see section 19(1) for precise details) in which to inform the provisional supervisor whether the veto power is exercised. Exercise of the veto power will at once terminate the provisional supervision. In practice, however, the proposed provisional supervisor will inevitably consult with secured creditors *in advance* and provisional supervision will not be commenced if a secured creditor makes it clear that the veto power will be exercised. (The recent reforms in UK with reference to floating charges have not influenced the Hong Kong debate in the slightest.)⁶

Where a secured creditor allows a provisional supervision to go ahead, the moratorium will apply to the secured creditor and prevent, for example, the appointment of a receiver or other steps to realize charged assets. Thus the secured creditor will be delayed from being able to enforce his rights, although under the new Bill the actual substance of those rights cannot be cut down without the secured creditor's consent. Except to the extent that he is under-secured, a secured creditor has no vote at the creditors' meeting.⁷

Lenders who are under-secured – which is not uncommon in the light of recent Hong Kong property and stock prices – may have greater willingness to forgo the exercise of the veto than a fully secured creditor. Nevertheless, it may well be in the interests of even a fully secured lender to allow a company to go into provisional supervision. Few banks will wish to see a customer go into liquidation, particularly if the exercise of a veto power will generate bad publicity. Moreover, principles of reciprocity will always be borne in mind: Bank A may well be fully secured in relation to Company X and would not be harmed if Company X were to go into liquidation rather than provisional supervision; but that may not hold true with reference to Company Y, in relation to which Bank A is under-secured and Bank B is fully secured. (Companies in Hong Kong tend to use several banks, rather than stick to one or two.) The same factors that operate in relation to the current non-statutory "Hong Kong Approach to Corporate Difficulties" (promulgated by the HKAB and the HKMA and modeled on the "London Approach"⁸) will influence the decision to exercise or not to exercise the statutory veto under the new Bill.

In theory the new Bill should have several advantages over the HKAB/HKMA guidelines. The new Bill applies to all creditors, not just banks, and has statutory force – a holdout creditor will have no option but to fall in line with everyone else in a provisional supervision (unless, as a secured creditor, it has a veto). In practice, however, it is likely that lenders, as well as companies themselves, will continue to favour an informal workout wherever possible. The appointment of a provisional supervisor – an independent third party supposedly looking after the interest of all the creditors – may be a bitter pill for the directors of a financially troubled company to swallow and, at the same time, may lessen the direct influence of a lender on any re-structuring plan. Nor should it be overlooked that most Hong Kong corporations (even those listed on the stock market) are family controlled and the perceived wisdom is that the family may be particularly unwilling to hand over control to an outside restructuring specialist. It remains to be seen whether the costs involved in appointing a professional insolvency expert as the provisional supervisor will be significantly less than costs incurred in an informal workout.

Conclusion

Whilst these commentators favour the introduction of legislation as early as possible – the phrase "better than nothing" being applicable – it would be most welcome if the Government were to drop the requirement that workers' wages must be paid up front in full. It is hoped that, after the current round of consultations, the proposed cap on payments will be adopted.

In any event, even after the legislation is (hopefully) put in place, it would perhaps be unrealistic to expect provisional supervision to have a major or immediate impact upon the number of successful corporate rescues and re-structurings in Hong Kong. Large companies, which already have their own professional advisers, will continue to favour informal workouts (and so will their lenders). Small businesses will not be able to bear the costs of a provisional supervisor and are unlikely, in any event, to act quickly enough to get a provisional supervisor in place before things are already too late. These last-mentioned considerations are also relevant to medium-sized enterprises, particularly as it would be foolish to underestimate the level of professional fees that are likely to be charged by insolvency practitioners (and their legal advisers) in Hong Kong. In addition, particularly for some medium-sized enterprises, the cost of paying off its workers' claims in advance – albeit with a cap – may yet prove to be a significant obstacle in the path of commencing a rescue attempt.

FOOTNOTES:

¹ This is an updated and slightly amended version of an article, Corporate Rescue: Hong Kong's New Legislation, that appeared in Hong Kong in 1 Banking Today at 32–33 (Sept./Oct. 2001). [Back To Text](#)

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⁴ See "The Companies (Corporate Rescue) Bill 2001, available at <http://law.hku.hk/staff/psm> (giving further details about new Bill, which also seeks to introduce concept of insolvent or wrongful trading into Hong Kong law). [Back To Text](#)

⁵ See Legislative Council, available at <http://legco.gov.hk/yr00-01/english/bc/bc12/minutes/bc121205.pdf> (setting forth further details). [Back To Text](#)

⁶ The recent White Paper, Insolvency: A Second Chance (Cm. 5234, July 2001) proposed to abolish the veto of holders of floating charges in relation to administration. These recommendations have now been incorporated into the Enterprise Bill, introduced to the House of Commons on Mar. 26, 2002. [Back To Text](#)

⁷ See The Companies (Corporate Rescue) Bill 2001, Seventh Schedule, ¶ 14, available at <http://legco.gov.hk/yr00-01/english/bills/c025-e.pdf>. [Back To Text](#)

⁸ HKMA, Quarterly Bulletin (November 13, 1999) available at <http://www.info.gov.hk/hkma/eng/public/qb9911/toc.htm>. [Back To Text](#)