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ARTICLE

Provisional Supervision in Hong Kong: Third Time Lucky?

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Introduction

Provisional supervision (PS) is Hong Kong's proposed new corporate rescue procedure. In essence, it is a procedure for the preparation by a professional, usually an accountant or a solicitor, of a proposal for a voluntary arrangement, supported by a moratorium. There should be little court involvement in the process and it is anticipated that the costs and delays of the process would be less than alternate, currently available procedures. This article will retrace some of the key events and issues arising from the numerous policy and legislative debates about PS in Hong Kong. At present the Hong Kong government is in the midst of drafting a new Bill on corporate rescue procedure to be introduced to the HKSAR Legislative Council. This will be the third attempt. Setting aside the controversies and the content of this new effort by the Hong Kong administration, the Global Financial Crisis in 2008 has signalled to the international policy and business community, free markets alone cannot be an effective regulatory mechanism. Having legal safeguards and clear rules to regulate procedures and conduct of market participants are imperative to avoid future financial meltdowns.

Background

PS was the recommendation of the Law Reform Commission of Hong Kong (LRC) and its sub-committee on insolvency, arising out of a reference to the LRC in 1990 to review the Bankruptcy Ordinance 1931 and the winding-up provisions of the Companies Ordinance 1932 and to consider corporate rescue legislation in other jurisdictions, in particular the UK Insolvency Act 1986 and Chapter 11 of the US Bankruptcy Code. The latter topic was considered important by the Administration, because during the shipping slump in the mid 1980s a number of major Hong Kong shipping companies (not least Orient Overseas Container Lines, the group headed by Tung Chee Wah, who after the handover in 1997 became the Chief Executive, formerly the Governor, of Hong Kong) had only narrowly escaped liquidation, emphasising the inadequacies of the existing law.

As a result of the reference to the LRC Hong Kong's bankruptcy law was reformed by the Bankruptcy (Amendment) Ordinance, No 76 of 1996, following the LRC's Report on Bankruptcy published in May 1995 (the provisions of the Amendment Ordinance came into force on 1 April 1998); in October 1996 the LRC issued a Report on Corporate Rescue and Insolvent Trading, which has not resulted in any new legislation (more on this below); then in July 1999 the LRC issued a Report on the Winding-up Provisions of the Companies Ordinance containing over 200 recommendations, few of which have yet resulted in legislation, because the Companies Ordinance as a whole subsequently became the subject of the Companies Ordinance Rewrite (see <wwwfstb.gov.hk/fsb/co_rewrite>), for which Liquidation is Phase 2 and has not yet commenced.

Corporate Rescue Report

A couple of special features of the Hong Kong situation should be noted before we look at the Report. First, there is no licensed insolvency practitioner regime in Hong Kong. Until the mid 1990s the Official Receiver's Office (ORO), a department of the Hong Kong Government, had had a virtual monopoly in insolvency matters – both personal and corporate – the numbers of which were, for cultural and other reasons, comparatively low. Private sector professionals had little involvement in insolvency work. In the mid 1990s the insolvency numbers were beginning to increase substantially and the ORO was finding it hard to cope with its own resources. In 1996 the Official Receiver started a scheme for briefing out certain types of insolvency

Notes

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work to the private sector and this has expanded over the years. The other special feature is that, despite being renowned as a *laissez-faire* society, Hong Kong has quite a number of social benefit interventions, one of which is vital to workers' attitudes to corporate rescue proposals. In 1985, after an uncertain time while Hong Kong's return to China was under discussion and the economy was down, the Government had introduced the Protection of Wages on Insolvency Ordinance (PWIO). This legislation created the Protection of Wages on Insolvency Fund, which is funded by a levy payable with the annual fee for a business registration certificate and which provides for the payment of specified sums (which increase from time to time) for arrears of wages, wages in lieu of notice and severance payment when a corporate employer is wound up or when a non-corporate employer is made bankrupt. The sums are paid within a few months of the liquidation or bankruptcy and are more generous than the equivalent sums payable by way of preferential payments in the administration of insolvent estates. On a payment being made by the Fund, it is subrogated to the worker's rights in administration. This early receipt of what may be quite substantial funds does not encourage workers to stick with an employer and try to save the business. In good economic times many workers would prefer to take their PWIO benefits and go round the block to get another job.

Looking now at the Report, it accepted most of the proposals of the LRC's sub-committee in its Consultation Paper published in May 1995 and which had received broad support. The sub-committee considered that the existing arrangements for corporate rescue were inadequate. Absent 100% creditor approval and a voluntary arrangement by way of debt rescheduling, etc, the principal statutory procedure in Hong Kong was, and still is, a scheme of arrangement under s 166 of the Companies Ordinance (the equivalent of Companies Act 1985 s 425, now Companies Act 2006 ss 899 *et seq).* The problems with this provision are well-known, eg lack of a moratorium, which allows a recalcitrant creditor to threaten winding-up; the need for at least two applications to the court; the inevitable delays and the high professional costs of this type of litigation. The LRC addressed these all these issues. First, as an encouragement for directors to start a rescue process and to avoid the difficulties in proving fraudulent trading under s 275 of the Companies Ordinance, the LRC recommended a new civil remedy of insolvent trading, liability for which was extended beyond directors to senior management who knew or ought to have known the company was insolvent and failed to warn the board.

The procedure for initiating PS was kept simple. In a typical case, where the company is in financial difficulty, but the directors think that there is a chance of saving the company or parts of it, they should enter into negotiations with the creditors and the person they want to be the provisional supervisor to discuss the possibility of the company going into PS. The name of the process, provisional supervision, was chosen to distinguish it from other similar processes in other jurisdictions, which the sub-committee had reviewed, such as administration, judicial management and examinership. As the procedure revolves around the person who is brought in to prepare a proposal for a voluntary arrangement and in that sense the process is provisional and, if successful, segues into a voluntary arrangement, the sub-committee considered that provisional supervisor was the best expression of that person's function and accordingly the process was called provisional supervision.

If the creditors were willing to consider PS, the board would resolve that the company go into PS and a provisional supervisor would be appointed. Copies of the resolutions, the appointment and a background affidavit (in order to identify which of the purposes of PS, to be stated in the legislation, eg, to achieve a more advantageous realisation of the company's property than would be effected on a winding up of the company, was to be relied upon and to give a basis for a remedy against the directors if they were abusing the process) would be filed in the Companies Registry and the High Court Registry. PS commenced on the last filing. The Report proposed that only solicitors and accountants could be provisional supervisors until a registered insolvency practitioner regime was established. Upon the commencement of the PS there was an initial moratorium of 30 days. In this period, in a simple case the provisional supervisor had to collect further information about the company, decide whether a proposal for a voluntary arrangement would achieve any of the purposes of PS set out in the legislation and, if so, prepare an arrangement plan. If there was no hope for the company, then he would call a meeting of creditors to resolve to wind up the company as a creditors' voluntary winding up. An extension of the moratorium up to a maximum of 6 months from the commencement of the PS could be made by the court. An extension beyond that required a majority vote of the creditors.

During the PS the powers of the directors are suspended, though the provisional supervisor could delegate day-to-day management powers to certain directors, if thought appropriate. The Report was strongly against the concept of the debtor in possession.

Other aspects of PS included the right of a major secured creditor, ie, a holder of a charge over the whole or substantially the whole of the company's assets to elect not to participate in the PS, whereupon the PS would immediately cease; and the recognition of super priority for the lending of funds as working capital for the company (existing lenders were to be given a first refusal on any super priority lending). What turned out to be the Report's most controversial aspect (see below) was the topic of workers' rights in PS. The Report, with hindsight, perhaps rather naively, recommended

that workers who were laid off as a consequence of the PS (and those who were retained but were owed arrears of wages, etc, from before the appointment of the provisional supervisor) should be entitled to similar payments as workers entitled under the PWIO. Until that change was effected, the Report recommended the introduction of a provision in PS analogous to s 79 of the Companies Ordinance (whereunder, on the appointment of a receiver under a floating charge, the preferential payments under s 265 of the Companies Ordinance on a winding up were to paid out of the assets coming into the hands of the receiver in priority to the chargee). If the provisional supervisor managed to put together a proposal for a voluntary arrangement, he would call a meeting of creditors to approve the proposal. The Report recommended a single class of creditors and that for the resolution to approve the proposal to be passed required a majority in number and in excess of two thirds in value of the creditors present in person or by proxy and voting on the resolution. The voluntary arrangement would take effect upon the approval of the resolution and it would bind all relevant creditors given notice of the meeting, the company, the members of the company and the supervisor of the voluntary arrangement.

The insolvent trading recommendations were a mixture of the UK wrongful trading provisions in the Insolvency Act 1986 and the then Australian Corporations Law insolvent trading provisions, but "responsible persons" included senior management, though their duties in respect of insolvent trading were less than the duties of directors.

Despite the generally supportive public reaction to the sub-committee's Consultation Paper and the fact that the LRC substantially supported most of the sub-committee's proposals, some of the recommendations of the Report, such as those on workers' entitlements and secured creditors, were to prove quite controversial. In the meantime, before any legislation based on the Report could be prepared, banks had accepted a process of debtor support.

HKAB/HKMA Guidelines on the Hong Kong approach to corporate difficulties

HKAB, the Hong Kong Association of Banks, issued the original version of Guidelines in April 1998. They were based on the Bank of England's London Approach, the underlying principles of which are bank support for the debtor company and cooperation between all creditor banks in a multi-bank situation. The Hong Kong Monetary Authority published a revised version of the Guidelines in November 1999 (for an overview of the HK Guidelines see (1999) 15 *Insolvency Law & Practice* 128 (Bannister)). While multi-bank situations are quite common in Hong Kong, the Guidelines are not appropriate or relied on in many cases.

Administration's reaction to the Report

Almost immediately after the Financial Services Bureau (FSB), the department with the carriage of any new legislation on corporate rescue and insolvent trading, started preparing for the drafting of the proposed legislation, it realised that there were some "incompatibilities" between the recommendations in the Report as to workers' rights, not just with the PWIO, but also with the Employment Ordinance. Accordingly, the FSB, once it was aware of the incompatibilities, initiated a 3 months' public consultation commencing on 22 December 1998 in order to gauge the views of interested parties, in particular the employers' and employees' organisations, the banking and financial sectors and practitioners involved in corporate rescue. This despite the fact that the Labour Department, the Federation of Hong Kong and Kowloon Labour Unions, HKAB, the Education and Manpower Branch were amongst those that had made submissions on the LRC's sub-committee's consultation paper. Comments were sought on the proposals set out in a consultation paper prepared by FSB (which can be found as Annex C to the Legislative Council Brief at <www.legco.gov.hk/yr99-00/english/bc/bc06/general>, where the report on the consultation dated 2 June 1999 can be found as Annex D). The consultation paper thought that use of the PWI Fund would represent a fundamental change to the purpose of the Fund and could lead to possible abuse by employers. It offered various alternative options and accepted that upfront payment by the company of all workers' entitlements would inevitably mean that PS would hardly ever be used. It has to be understood that Hong Kong is different from most of the jurisdictions reviewed by the LRC sub-committee in that it has a very limited unemployment social security benefit. Against conflicting views on the other options, the result of the consultation left only the option that the company must clear all arrears/statutory entitlements of employees that it laid off during the relevant period and accordingly the FSB said it would proceed with the draft legislation on that basis.

Companies (Amendment) Bill 2000

This Bill, which included some technical amendments to various provisions of the Companies Ordinance, was principally devoted to legislating to give effect to the LRC Report on Corporate Rescue. A draft of the Bill (then the proposed Companies (Amendment) (No 2) Bill 1999) had come before Standing Committee on Company Law Reform at its meeting on 14 December 1999 and met with some resistance. The Administration was asked to reconsider the draft in the light of the Committee's comments. The Companies (Amendment) Bill 2000 was gazetted some 3 weeks (which included the Christmas and New Year holidays) later on 7 January 2000!

Clause 24 of the Bill added a new Part IVB (ss 168U to 168ZZA) to the Companies Ordinance entitled Provisional Supervision and Voluntary Arrangements. Clause 168ZA(c)(iv) refers to the requirement for the company to pre-pay all workers' entitlements under the Employment Ordinance or establish a trust account for such purpose. Another significant change from the Report was that a "major creditor"(who could elect not to proceed with PS, causing the PS to terminate) was now defined not only as the holder of a charge over the whole or substantially the whole of the company's property, but the claim under the charge must not be less than 33.3 % of the liabilities of the company. Clause 44 of the Bill added new sections 295A to 295G to cover Insolvent Trading and in regard to this the scope of the persons potentially liable, besides directors and shadow directors, was reduced by limiting the management group to managers who were involved to a substantial or material degree in directing the company's business or affairs.

The LegCo Bills Committee on the Bill was not wholly unsympathetic to the Provisional Supervision and Insolvent Trading provisions in the Bill. It held 8 meetings between 22 February 2000 and invited submissions on policy and technical aspects from interested parties. The Chairman thought the trust account proposal too inflexible. What if workers were prepared to accept less than their full entitlement to keep their jobs ? The deadline for submissions from interested parties had to be extended. FSB needed to get back to the Labour Advisory Board for its views on a more flexible trust account. With the expiry of the term of that LegCo imminent, it was going to be impossible to deal with the PS clauses in time and at the meeting on 10 April 2000 it was decided to excise the PS and insolvent trading provisions from the Bill.

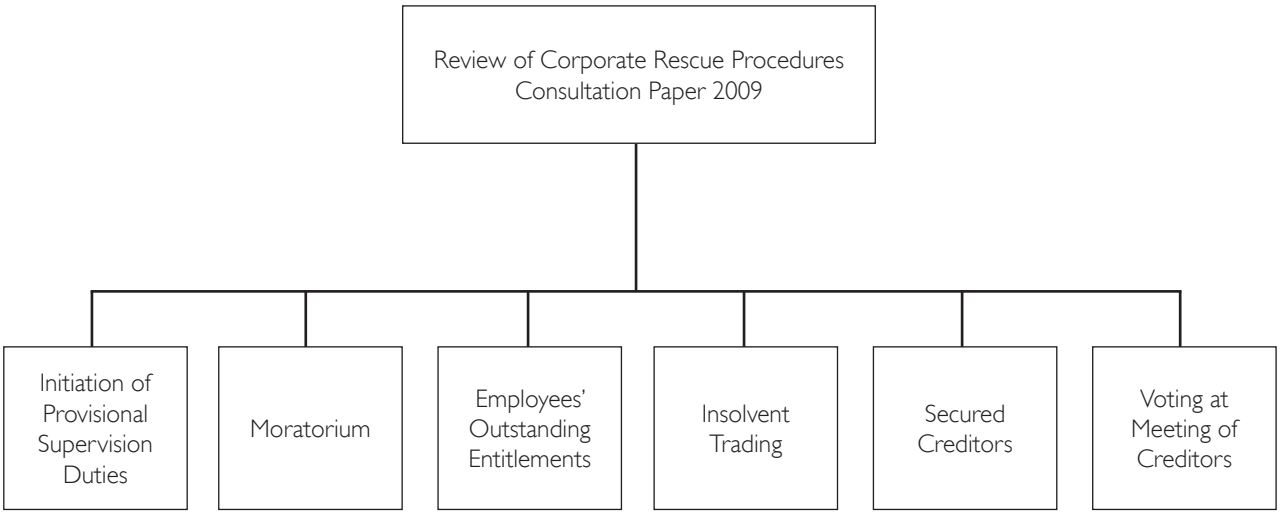
Companies (Corporate Rescue) Bill 2001

The Administration was back for a second attempt with this Bill, which was gazetted on 18 May 2001. In late 2000 FSB had consulted with the PWIF and LAB and both had objected to any flexibility for the trust account requirement and insisted full pre-payment before PS could start. The flexibility being suggested was deferral of payment and trade-in of entitlements for shares in the company (see Introduction of a Statutory Corporate Rescue Procedure for Hong Kong Report on Consultation on the Proposed Flexibility on the Settlement of Outstanding Wages and Other Entitlements, Annex C to the Legislative Council Brief (see <www.Legco.gov.hk/yr00-01/english/bc/bc12/general>. The Bill was substantially the same as the earlier Bill. There were slight differences, e,g, in that payment out of the trust account had to be made as soon as practicable and, except in circumstances where there were good and sufficient reasons, before the meeting of creditors to consider the proposal. A bills committee was set up to consider the Bill. It held five meetings. It invited submissions from 46 interested parties! The general view was that the requirement to pay employees' entitlements or to set up a trust account for payment would mean that PS would rarely, if ever, be used. A proposal by the Administration to cap the amount payable to the equivalent amounts payable by the PWI Fund (ie HKD 258,500) was considered at the fifth meeting. At the end of 2001 it was decided to hold the Bill in abeyance, while the Administration would continue to consult. In September 2003 FSB issued a consultation paper on its capping proposal (see <www.legco.gov.hk/yr00-01/english/bc/bc12/papers> Annex A and B). In June 2004 the Administration reported the result of the consultation to the Bills Committee on the Companies Corporate Rescue Bill. No further action was taken and the Bill lapsed on 22 July 2004 at the end of the term of office of that Legislative Council. While all this consultation was going on, progress in corporate rescue was being made by judicial intervention.

Provisional liquidators and corporate rescues

Prior to the decision in *Re Keview Technology (BVI) Ltd* [2002] 2 HKLRD 290, provisional liquidators appointed under s 193 of the Companies Ordinance could not attempt a corporate rescue. The appointment of a provisional liquidator was considered as a temporary, passive position to preserve the assets of the company between the presentation of a winding up petition and the making of a winding up order and the appointment of a liquidator. *Keview*, following English decisions, changed the practice and it became common place for provisional liquidators to be given power to attempt a corporate rescue. Section 186 of the Companies Ordinance provides that upon the making of a winding up order or the appointment of a provisional liquidator, no action or proceeding shall be proceeded with or commenced against the company except by leave of the court. It provides the moratorium that s 166 fails to provide. There was a slight hiccup in 2006 when some doubts were raised by comments by Rogers V-P in the Hong Kong Court of Appeal in *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192, where he queried that perhaps s 193 was being used improperly and at para 35 said that there was a significant difference between the appointment of provisional liquidators on the basis that the company is insolvent and the assets were in jeopardy and the appointment of provisional liquidators solely for the purpose of enabling a corporate rescue to take place. In the *Legend* case the main asset was a casino in the Philippines and a local insolvency practitioner had already been appointed there under a rehabilitation procedure. Despite some gloom by some commentators (see, eg, (2007) 4 *International Corporate Rescue* (2) 75, Golding and Dunne), Hong

Figure 1



Kong courts have continued to make orders giving provisional liquidators power to attempt a corporate rescue (see *Re Plus Holdings Ltd* [2007] 2 HKLRD 725, where the company's only asset was its listing and the *Legend* case was referred to).

Before *Legend* the need to press ahead with PS was being doubted given the availability of s 193 and, despite *Legend*, s 193 is still a fall back if PS should never materialise. Indeed, little was happening about PS after the lapsing of the 2001 Bill until the recent global financial crisis when the Hong Kong Government decided to revive its efforts to introduce PS.

Review of corporate rescue procedure legislative proposals

The issue of PS re-surfaced again when the Hong Kong Government's Task Force on Economic Challenges recommended in late January 2009 that the Government should reconsider introducing a corporate rescue procedure to address future short-term financial difficulties of companies, as part of measures to combat problems from the fallout of the global economic crisis in 2008. In October 2009, a Consultation Paper was released to seek public input on the review of corporate rescue procedure.

The Government was intending to use this consultation and the outcomes of the process to amend the 2001 Bill and introduce a revised Bill to LegCo in 2010-11. Figure 1 identifies the seven areas addressed in the Consultation Paper

The Consultation Paper contains 43 pages and seeks answers to 19 questions (see <www.fstb.gov.hk/fsb/ppr/consult/doc./review_crplp_e.pdf)>. In this attempt, the Government has taken into account of the objections from various stakeholders to the 2001 Bill and made some effort to address those concerns. On the controversial topic of employees' outstanding entitlements, the Paper repeated the "2003 Proposal" of capping the trust account to mirror that of the PWIF and that the voluntary arrangement proposal must provide for payment of any outstanding amounts above the cap within 12 months of the approval of the proposal. In addition the Paper offered two alternative options. Alternative A was to exempt employees who are owed wages or other entitlements from the moratorium, so that they could petition to wind up the company. Alternative B (the Booth/ Smart Proposal, proposed by Professor Charles D Booth and the late Professor Philip Smart in (2001) 31 HKLJ 188) provided that arrears of wages and other entitlements under the Employment Ordinance (subject to the PWIF caps) were to be treated as "employees' protected debts" and the provisional supervisor's proposal must contain provisions that such debts be paid by the time the voluntary arrangement comes into effect and any balance (above the caps) must be paid within 12 months. On default of payment, creditors' voluntary winding up would follow. There would also be an amendment to the PWIO, to provide that where creditors' voluntary winding up occurred under PS the PWIF would apply.

The Consultation ended in January 2010. 59 submissions were received, including six from individuals and 53 from organisations. Submissions were mainly from professional bodies, financial institutions, practitioners, professionals and academics. Some new topics were raised in the submissions, such as creditors being able to initiate PS. The Administration thought this might complicate the process, but agreed to review the situation after PS was introduced. As a result of submissions, the Administration went back on its position under the 2001 Bill to exempt all post-commencement of PS debts from the moratorium in favour of exempting

only post-commencement arrears of wages and other entitlements under the Employment Ordinance and employer's contributions under the Mandatory Provident Fund Schemes Ordinance (MPFSO) or Occupational Retirement Schemes Ordinance (ORSO). The exemption from the moratorium for significant hardship proposed in the earlier Bills would be replaced by a general power in the court to grant exemption where it thinks fit. The initial moratorium period would be extended from 30 days to 45 working days.

In July 2010, the Hong Kong Government released the Consultation Conclusions (see <www.fstb.gov.hk/consult/doc/review_crplp_conclusions_e.pdf>. This document summarised the contents of the public submissions and the government's responses to those views. Overall, the public submissions were uncontroversial. On the length of the initial moratorium period, there was some support for period of 60 or even 90 days, but the Government's response was to stick with 45 days, but, as suggested by one submission, express all time durations in the legislation as working days. On the length of a court extension of the moratorium, the Government had proposed a period not exceeding a maximum of 12 months from the commencement of the PS. The majority of responses disagreed with that and the Government's response was not to limit the court's discretion to extend the moratorium period. Whilst the respondents were split on the matter of the qualification requirements for provisional supervisors, the Government stuck to its original proposal to allow all registered certified public accountants and practising solicitors to take up appointment as provisional supervisor.

On employees' outstanding entitlements (EOEs), although Alternative B had majority support and was favoured by the business and banking sectors and practitioners, in view of the objections taken by the PWIF board, the Labour Advisory Board and labour sector representatives, the Administration decided to adopt a phased payment schedule for pre-commencement EOEs as follows:

(a) arrears of wages should be paid, up to the PWIF cap (i.e, HKD 36,000) by the 30th calendar day after the commencement of the PS;

(b) for employees whose employment had been terminated before the commencement of the PS, any outstanding wages in lieu of notice and severance payments should be paid, up to the PWIF caps, within 45 calendar days after the voluntary arrangement has been approved, or, if the initial moratorium period is extended, within 45 calendar days from the date of extension;

(c) any remaining pre-commencement entitlements, including outstanding employers' contributions under MPFSO or ORSO, should be paid in full within 12 months after the voluntary arrangement has come into effect;

(d) if the company fails to pay according to the above schedule, the employees concerned will no longer be bound by the moratorium and may petition the court for winding up the company; and

(e) to facilitate employees to take legal action against the company in case it fails to pay according to the above schedule, the provisional supervisor will be required to verify the details of debts owed to employees prior to the commencement of the PS with employees within 30 days after the commencement of the PS.

Commentary and conclusions

The passage to enact legislation on a new corporate rescue procedure has been a long one for Hong Kong. The journey began with the LRC recommendations in 1996. Along the way, there have been two failed attempts, both caused by time running out, in trying to resolve the complexities involved in trying to protect the interests of workers. This may seem strange for a place like Hong Kong, not well known for its protection of workers in other contexts. But, as mentioned above, the unemployment benefits (payable under the Comprehensive Social Security Scheme) are small.

This time under the pretext of the recommendations made by the Task Force in response to the global economic crisis, the Government is attempting to introduce a new Bill on PS to the Legislative Council. Even though economic crisis can be a catalyst for change, the Government was cautious in its approach. The 2009 Consultation Paper not only addressed past objections of respondents, but the Consultation Conclusions took on board most of the views expressed in the public submissions. In any event, thanks to being the gateway to China, Hong Kong has come through the global economic crisis pretty much unscathed, so the pressure for PS is off.

On the broader level, the Global Financial Crisis in 2008 had revealed the vulnerabilities of free markets and the capitalist mantras. Markets do fail and they can fail in spectacular fashion. Whilst many would think it was the opportunistic behaviour of a few that created the economic woes in 2008-9, they did not take into account the market thrives on speculative gains where opportunism is the rudiment of profit maximisation. Thus, it is unrealistic to make provisions to only regulate products and impose restrictions or additional duties on some market participants. The combination of formal and informal rules is required to ensure at times of crisis market participants will not over react and order is restored. Having robust PS is one such regulatory instrument.

This will be the third attempt by the Hong Kong Government to enact PS. On the one hand, whilst the Hong Kong administration is cautious and made efforts

to build consensus for the 2009 PS proposals, there is no guarantee that the third time will be lucky. On the other hand, one lesson the global economic crisis has conveyed to policy makers around the world is – growth is not the only mantra of a healthy market, corporate restructure and saving companies from insolvency is an important tool to correct market failures. Only time will tell if the Government got it right this time.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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