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ADVISORY

Provisonal Supervision & Insolvent Trading in Hong Kong

Introduction

This article gives a brief overview of the proposed new legislation relating to Provisional Supervision and Insolvent Trading. This legislation has been in the pipeline for the last 20 years or so, but this time there seems to be a genuine will on the part of the Administration to press ahead with bringing this back to LegCo, hopefully passing it before the end of the current LegCo session which expires in 2016.

We will look at:

- the appointment and formalities of a provisional supervisor including who is appointed;
- the duties and powers of the provisional supervisor;
- how is it envisaged the process will work from the time of the provisional supervisor's appointment to the final meeting of creditors;
- how employees will be treated; the construction and contents of the voluntary arrangement proposals; and
- the issue of insolvent trading, which if passed, will, for the first time, give the power to the courts to impose personal liability on directors of insolvent companies in circumstances were they have failed to take action on a timely basis.

It is important to emphasise that this legislation is not Hong Kong's answer to Chapter 11 in the US. Agreed, the hoped-for outcome, that is the rescue of a company; the saving of its business; the retention of employment etc, or a mixture of these, all of which contribute to the benefit of all stakeholders, is the same in either process. The fundamental difference is that under the Chapter 11 process, existing management, that is management that has often been responsible for the company getting into its current difficulties, remains in control of the business, whereas in the Provisional Supervision process control and management of the company is handed over to a professional, experienced in these matters, whose role is to ensure that the process operates in a transparent manner and that the interests of the creditors of the company are properly protected.

An Overview Of Provisional Supervision

The intention behind the Provisional Supervision process is to provide a distressed company with a viable option for turning itself around and rescuing its business, or part of it, as opposed to going into liquidation. It is envisaged that the process will be supervised by an independent third party (the provisional supervisor) whose initial role will be to safeguard the affairs of the company, consider options for its rescue and put proposals before its creditors in the form of a voluntary arrangement. All this will be driven by a tight timeframe set out in the legislation which is designed to ensure that the process moves forward in a timely manner.

As part of the process, once the provisional supervisor has been appointed a moratorium will come into force which will, in effect, prevent creditors from taking action against the company, (unless there are exceptional circumstances), whilst the provisional supervisor formulates a rescue plan.

To protect the interests of the employees of the company, safeguards have been built into the legislation to ensure that they are no worse off than they would be in the case of a liquidation.

The intention is that this procedure, which will predominantly take place out of court, will be more cost-effective and speedier than the current forms of corporate rescue presently available in Hong Kong at the This This amendment resolves that potential dilemma, but still leaves one outstanding issue which, This amendment resolves that potential dilemma, but still leaves one outstanding issue which, subject of course to the eventual wording of the bill is likely to require clarification by the court at some later date. This relates to a creditor with a charge, but where that charge has no economic value. It is often the case that the assets of the company which are subject to the first charge are of insufficient value to meet the amount outstanding to the charge holder. In these circumstances, even if a charge holder comes within the definition mentioned above, would he still have the ability to object to the appointment of a provisional supervisor even though the security is of no economic value.

Appointment and Formalities

For a company to avail itself of the protection afforded by the appointment of a provisional supervisor it will need to show that it is insolvent or it is likely to become insolvent. The insolvency test can be satisfied by using a mixture of the cash flow test and balance sheet test as set out in section 178 of the Companies (Winding-up and Miscellaneous Provisions) Ordinance.

The appointment of a provisional supervisor can be either by the company, or by a liquidator or provisional liquidator. If the appointment is by a liquidator or provisional liquidator it will only be capable of being done with the consent of the court and in that case the appointment must take place within 10 business days of the court order.
However, in both cases, it will be necessary to have the prior written consent of the major secured creditor before an appointment can take place. The proposed wording is not dissimilar to that used in England and Wales in respect of the appointment of Administrators under the provisions of the Insolvency Act. The definition of major secured creditor is

> *"the holder of a charge, whether fixed or otherwise over the whole or substantially the whole of the company's property or the holder of two or more charges whether fixed or otherwise on the company's property with a property subject to those charges constitutes the whole or substantial whole of the company's property."*

In previous incarnations of this bill, major secured creditors were given a short period, following the appointment of the provisional supervisor, during which they could object to such an appointment. This would

have raised the possibility of a provisional supervisor being appointed and then having to vacate office if the major secured creditor objected either to their appointment, or alternatively desired the appointment of someone else as provisional supervisor.

This amendment resolves that potential dilemma, but still leaves one outstanding issue which, subject of course to the eventual wording of the bill is likely to require clarification by the court at some later date. This relates to a creditor with a charge, but where that charge has no economic value. It is often the case that the assets of the company which are subject to the first charge are of insufficient value to meet the amount outstanding to the charge holder. In these circumstances, even if a charge holder comes within the definition mentioned above, would he still have the ability to object to the appointment of a provisional supervisor even though the security is of no economic value.

Who can be Appointed as Provisional Supervisor

Based on the government's latest proposals, the only people who will be eligible to be appointed as provisional supervisors will be Certified Public Accountants or solicitors with practising certificates. They are regulated respectively by the HKICPA and the Law Society of Hong Kong.

Surprisingly, in view of the potential complexity of the type of work involved, there is nothing in the current proposals which provides for the provisional supervisor to necessarily have any experience of undertaking work of this highly specialised nature. It is unfortunate that the Administration appears to be unwilling to allow people with experience of this type of work, but who may not be members of either of the above two bodies, to be appointed as provisional supervisors.

It is likely that further submissions will be made to LegCo during the Bills stage on this particular issue given the number of experienced people in Hong Kong who would be excluded by this provision. However, as these submissions have already been made previously, it seems increasingly likely that they will again be ignored.

Effects of the Appointment of the Provisional Supervisor

Immediately following the appointment of a provisional supervisor, a moratorium will come into force. In practice, this will mean that virtually all legal proceedings against the company will be stayed, and except with the consent of the court, creditors will not be able to commence any new proceedings. If a receiver has previously been appointed, he will not be able to exercise any of his functions and the provisional supervisor has the right to take over any company property held by the receiver. He may even request the receiver to vacate office. In addition, any transaction relating to the disposal of the company's property after the appointment of the provisional supervisor will be void, unless entered into by the provisional supervisor or approved by the court.

In practical terms this will mean that immediately following his appointment the provisional supervisor will exercise almost total control over the affairs of the company. The implementation of the moratorium will then give the provisional supervisor a period during which to assess the financial position of the company and, hopefully, formulate a rescue plan to be put before the company's creditors in due course.

However, the moratorium will not apply to certain claims of employees, which if not dealt with according to the proposed phased payment schedule (which is looked at below), would allow an employee to, for example, petition for the winding-up of the company.

Provisional Supervisor's Powers and Duties

According to the draft proposals, the key duties of the provisional supervisor will be to review the financial affairs of the company and decide whether it is in the best interests of the creditors to:

- implement a voluntary arrangement;
- wind-up the company; or
- bring the provisional supervision process to an end.

The provisional supervisor will be required to lodge reports with the Official Receiver's Office if he believes that any past or present officers of the company have been guilty of offences in relation to its formation and its operations. Although the draft legislation does not specify these offences, it appears that they are likely to be those presently set out in sections 271, 276 and 277 of the existing legislation. However, we will have to wait for the publication of the draft bill before knowing this for certain.

The provisional supervisor will also be responsible for calling the first and final meetings of creditors and reporting to creditors on the outcome of those meetings.

The powers of the provisional supervisor appear to be quite wide-ranging. He will be able to continue to run the business, close or dispose of any part of it as he sees fit; he will be able to appoint and remove directors; seek directions of the court and effectively do whatever is necessary for the purpose of the provisional supervision.
He will also have the power to dispose of any property which is the subject of a floating charge, although the floating charge holder will be entitled to the proceeds of sale of such property.

Personal Liability of the Provisional Supervisor

A provisional supervisor will be personally liable for any new contracts entered into by him following his appointment. This includes any contracts of employment. He will also be personally liable for any pre-appointment contracts, (and this again includes contracts of employment), which are adopted by him in writing. It is proposed that he will have 16 business days from the commencement of the provisional supervision to decide whether to adopt any pre-appointment contracts. Key here appears to be that he will not be deemed to be personally liable if he does not take positive steps to adopt the contracts. Previous iterations of the draft legislation appeared to envisage that he would be deemed to be personally liable in the absence or taking positive steps to avoid personal liability i.e. actually adopting a contract in writing. The current version is seen as a significant change in the drafting, reflecting concerns expressed by a number of those who would be tasked with implementing provisional supervision in practice.

Interestingly, the period for which the provisional supervisor will be personally liable is potentially quite limited. It is from the date on which he adopts the contract to the end of the provisional supervision period. It would therefore seem that in practice the period for which he is personally liable should be relatively short in duration, bearing in mind that the final meeting should be held within 45 days of the provisional supervisor's appointment. This will of course depend on time it takes for any voluntary arrangement proposal to be prepared and put before creditors for approval.

The provisional supervisor will have the right to contract out of personal liability if this can be agreed with the contracting party. He will also have an indemnity out of the assets of the company in respect of any liabilities which he assumes personally. This indemnity will priority to the claims of all floating charge and unsecured creditors.

Meetings of Creditors and Investigation Powers

First Meeting of Creditors

The provisional supervisor is required to convene a first meeting of creditors within 10 business days of the date of his appointment. He must give at least 7 days notice of this meeting and although the current draft of the proposals make no reference, it is reasonable to assume that it will be necessary to hold the meeting at a place and time that is convenient for the majority of creditors.

Convening the meeting within this timeframe is likely to pose practical difficulties for the provisional supervisor, particularly if the accounting records of the company are not up to date – a common enough problem with companies that are experiencing financial distress. The 10 business days requirement effectively gives the provisional supervisor a relatively short time-frame within which to assemble an accurate list of the company's creditors from its accounting records and send out notices. Our assumption at the moment is that it will be necessary to send the notice of the meeting by post. It would be a very progressive approach, although unfortunately unlikely, if the provisional supervisors were to be given the option to communicate with creditors by electronic means, rather than being limited to "snail mail". Certainly this is not an issue that has been dealt with as part of the consultation process to date. However, it is hoped that the draft provisions being considered as part of the updates to the Winding-up provisions of the Companies Ordinance may make their way into this legislation when the draft Bill is place before LegCo.

At the meeting, the provisional supervisor is required to table a "declaration of relevant relationships" as a means of enhancing transparency as regards his appointment. In addition, if the provisional supervisor is being "funded", details of this funding must also be disclosed at the meeting to allow creditors to decide whether or not it creates any potential conflict of interest.

The purpose of the first meeting of creditors is to decide:

- whether or not the existing provisional supervisor should continue in office; or
- whether he should be replaced; and
- to appoint a committee of creditors, the functions of which would be to appear to be similar to those of a committee of inspection in a liquidation.

It seems likely that the functions of the committee will be set out in more detail in the actual Bill, when it is published.

The provisional supervisor's powers extend to requiring present and/or former officers of the company to provide a statement of affairs and, in quite broad terms, to assist the provisional supervisor in the undertaking of his functions.

Final Meeting of Creditors

The final meeting of creditors is supposed to be held within 45 working days of the appointment of the provisional supervisor. However, this time can be extended for up to 6 months with the approval of a meeting of creditors. It can be further extended (for a period to be decided by the court), but only on the application of the provisional supervisor.

The purpose of the final meeting of creditors will be to either:

- approve a voluntary arrangement, (with or without modifications);
- decide whether the company should be wound-up; or
- terminate the provisional supervision.

Voting Majorities

The issue of the majorities required to approve a voluntary arrangement has been a movable feast during the various iterations of this draft legislation. The current position, as put forward by the Administration, is that it will require a majority in value of two thirds and a majority of 50% of those present and voting to pass a resolution approving a voluntary arrangement proposal.

In addition, in order to avoid creditors connected with the Company, management or shareholders pushing through proposals which might be to the detriment of the general body of unconnected creditors, there is a further provision that at least 50% in value of non-connected creditors must vote in favour of the proposal. For the avoidance of doubt, the majorities required relate to creditors who are actually present or represented and entitled to vote at the meeting. For resolutions other than the approval of the voluntary arrangement proposal, the majority in value is reduced to 50%.

There are strong arguments in favour of removing the "headcount rule" and replacing it with a larger majority in value, such as say 75%, as is the case with individual voluntary arrangements. The continued inclusion of the headcount rule appears to be a backward step for which no real explanation has been put forward by the Administration. It seems likely that this will be brought up again at the LegCo committee stage when it is to be hoped that a majority in value figure can be agreed as being a better alternative.

End of the Provisional Supervision

The provisional supervision will effectively come to an end following the final meeting of creditors. The outcome of the meeting should be either the acceptance by the creditors of a voluntary arrangement proposal or alternatively a decision to wind-up the company and place it into voluntary liquidation as at the date of the meeting of creditors. This will be deemed to be the date that the liquidation commences for anti-avoidance provisions.

The provisional supervision can also come to an end if the first creditors meeting is not held within 45 days and no application has been made to extend that time, nor has the sanction of creditors been sought to extend the time.

Private Examination

This is an interesting part of the legislation in that if gives liquidator-like powers to the provisional supervisor, but in a coporate rescue scenario.

The draft envisages that a provisional supervisor might apply to court for someone to be examined pursuant to, it is assumed, provisions that are similar to those in s.221 of the Companies (Winding-up and Miscellaneous Provisions) Ordinance. Whilst this seems like an attractive power for the provisional supervisor to have available to him, in practice it is difficult to see how he will be able to exercise this power in the relatively short period for which he is in office.

In a liquidation, it invariably takes many, many months to obtain an order pursuant to s.221 and for the examination to then take place. This is particularly the case when the application is contested. Given that the final meeting of creditors, at which the company's voluntary arrangement is to be proposed, is scheduled to take place within 45 days of his appointment it is difficult to see how the private examination powers can be properly enforced within that time-frame.

Having said that, if it transpires that a voluntary arrangement is not an appropriate way forward and the company eventually proceeds into liquidation, those powers are available to the liquidator in any event. It is also possible, because the period within which the final meeting is to be held can be extended by up to 12 months, that on certain occasions this power could be usefully exercised by a provisional supervisor for the benefit of the creditors.

Employees' Pre-Appointment Entitlements

Introduction

The treatment of employees and their pre-appointment entitlements is the issue which has caused the previous two failures of this legislation to pass through LegCo.

Before considering the current provisions it is worth asking why this part of the proposed legislation has caused so much angst and why it has delayed the implementation of the bill for so long.

The original proposals, provided for all the entitlements, of all employees, (including those of the directors), **to be paid in full before** (our emphasis) provisional supervision could even start! The natural argument against this was – how can a company, which is so financially distressed that it needs to seek protection from its creditors, pay all the claims of its employees?

Subsequent iterations of the draft legislation simply tinkered with this proposal and for this reason were seen by many stakeholders as being unworkable. These same stakeholders are unanimous in their agreement that the rights of employees, probably the must vulnerable of all those involved in the corporate rescue process, must be properly protected. However the proposals as they were originally formulated would, in the opinion of many, have resulted in a piece of legislation that was simply not fit for purpose.

What Is On The Table Now

The latest version of these provisions seeks to strike a fair balance between protecting the rights of employees and at the same time facilitating the rescue of an insolvent employer. As a side note, it would have been easy for this issue to have been resolved many years previously had the Administration been prepared to allow employees of companies entering into provisional supervision to make claims against the Protection of Wages on Insolvency Fund Board. After all, the employer is insolvent and the purpose of the fund is to protect the interests of employees!

Unfortunately, the approach of the Administration seems to be not to use public funds to facilitate the rescue of distressed companies, even though by doing so it might contribute to their rescue. The other side of this argument is that if a company fails because it cannot meet the claims of employees as set out in the revised framework, then its employees will still have claims against the fund and any economic benefit from the continutation of the business will be lost.

However, the Administration has throughout opposed this approach and accordingly has come up with a revised framework to deal with the claims of employees.

The revised framework envisages the following:

- For current employees, that is someone employed on the date the provisional supervisor is appointed, any arrears of wages due before the commencement the provisional supervision must be paid by the 30th day after the appointment of the provisional supervisor. (It is not clear if this is working days, but in keeping with the way other timings are set out in the proposals, it is probably simply 30 days.) The amount to be paid will be up to the limits currently prescribed by the PWIF. This is described as the first phased payment.

- The second phased payment, which has to be made within 45 days after the voluntary arrangement has been approved, or such other time to which it has been extended, is in respect of the employees' statutory entitlements to wages-in-lieu of notice, severance pay and holiday pay (again up to the limits set out in the PWIF); and

- Any further entitlements are to be paid within 12 months after the voluntary arrangement has been approved. This is known as the third phased payment.

It's important to note that if this phased payment schedule is not kept to, the employees will no longer be bound by the moratorium and would be entitled, among other things, to apply to the court to wind-up the company.

What does not appear to be dealt with in the proposals is any claims that employees, and in particular directors, may have in respect of other relationships which they have with the company. For example, a director who has a service contract with the company which runs for a period of years would, in theory, have a claim against the company for the residual amount due under the remaining period of the contract. This does not appear to come under any of the above headings/phased payments – unless it is part of the third phased payment. It remains to be seen whether, when the draft bill is published, it places any limits on the amount employees can claim perhaps by reference to claims pursuant to the PWIF.

Directors

At present, the PWIF does not make any payments out of the Fund to directors of companies, although if the company goes into liquidation those same directors would still have a right to make a claim to be paid alongside all other creditors. It will be interesting to see how the draft bill approaches this issue, if at all. In the absence of any statutory provision, it appears that directors will be able to be paid out their entitlements in full in a provisional supervision, but not in a liquidation.

If this is the case, it is possible that there may be a predisposition on the part of directors of insolvent companies to opt for provisional supervision as opposed to liquidation. After all, even if the provisional supervision fails after a few months, the directors' entitlements to their wages, pay-in-lieu, severance pay and holiday pay may all have been met out of the company's funds prior to the company going into liquidation where as in a liquidation the PWIF would not meet these claims.

Insolvent Trading

In the eyes of many people in Hong Kong, the most important part of the new corporate rescue legislation is that relating to Insolvent Trading.

Very similar to wrongful trading in the UK, the purpose of this legislation is to encourage directors of distressed companies to act sooner rather than later, and by doing so to protect the interests of creditors. If they don't, it gives the power to a liquidator to apply to the court for a declaration that the director be personally liable for some or all of the company's debts that have been incurred because the company continued to trade whilst it was insolvent.

What Is Insolvency

It seems that the proposed legislation will adopt the current insolvency test from the Companies (Winding-up and Miscellaneous Provisions) Ordinance, being a mixture of the cash flow test (the inability to pay its debts as and when they are due); and the balance sheet test (not having sufficient assets to pay its debts in full). In other words, if a company fails either of the two tests, it can be deemed to be insolvent.

Who Could Be Liable

These new provisions would apply to both directors and "shadow directors" as currently defined by s.2 of the Companies Ordinance. A shadow director is generally viewed as being someone "upon whose instructions the company is accustomed to act".

What Is Insolvent Trading

Insolvent trading takes place where:

- a company is insolvent (using either of the two tests);
- it continues to trade and incur further debts; and
- the director knew or ought to have known that the company would not be able repay those debts.

In other words, if the director:

- allows the company to continue trading;
- it incurs further debts which it is unable to pay; and
- it then goes into insolvent liquidation

there is a possibility that the director(s), (or shadow director(s) as the case may be) could be made personal liable for some or all of the debts incurred.

- In determining the knowledge of the director as to whether or not the company was insolvent at the time, the director will be judged on the basis of:-
- the general knowledge, skill and experience that can reasonably be expected of a person carrying out the same functions as carried out by that director in relation to the company; and
- the general knowledge, skills and experience that the direct actually has.

If the legislation is enacted as envisaged it will inevitably put greater pressure on directors who "should know better" than to allow a distressed company to continue trading without considering the position very carefully. At the same time, given recent case law, particularly that in relation to the disqualification of directors, it appears unlikely that a director will be able to hide behind the excuse that he did not have sufficient information to be aware of the company's position; (he should have made himself aware of the Company's financial position). Nor is it likely that a director will be able to hide behind the excuse that he did not have the necessary skills and experience; (in that case, he should not have been acting as a director in the first place).

Possible Defences

As with the legislation in the UK, it seems that the key defence a director will be able to put forward is that he took all reasonable steps to prevent the company from incurring the debts referred to. It is also envisaged that if the director has taken steps to seek to rescue the company, possibly through the new provisional supervision process, that this will similarly constitute a defence to an insolvent trading case.
It is also likely that a good defence to an insolvent trading claim would be that the director, whilst allowing the company to continue to trade, took all the necessary steps to improve the company's position; to return it to profitability; to reduce costs and to take such steps as were appropriate to improve as far as possible the position of the unsecured creditors.

Compensation

It is important to appreciate that an insolvent trading application can only be made by the liquidator of the company. In other words, the legislation only "kicks in" once the company has gone into insolvent liquidation. Importantly, the proposed legislation specifies that any compensation would not be subject to any pre-exising legal charge over the assets of the company, whether that be either a fixed or a floating charge, meaning that it would be available for the benefit of the unsecured creditors of the company.

Conclusion

When these provisions were first suggested, it was envisaged that "senior management" would also be subject to possible insolvent trading claims. For a variety of reasons, which make sense, that provision has now been removed from the draft legislation.

However it is imperative that the current version of the legislation is not watered down when it comes before LegCo.

Provisional supervision and insolvent trading go hand-in-hand. They form a "carrot and stick" approach.

The carrot for directors is that if the company is in difficulties they now have a formal corporate rescue process, that is provisional supervision, which can be utilised to create a moratorium to give the company or part of its business an opportunity to be rescued in one form or another.

The stick is that if the directors do not act in a responsible manner, i.e. when faced with an insolvent company, among other things they:

- allow it to continue to trade;
- to incur further credit which they know or must reasonably believe is not going to be paid;
- where they cannot reasonably believe that it can avoid insolvent liquidation;
- where they themselves benefit from the continuation of trading, particularly through the continued payment of their own remuneration when creditors remain unpaid;

then they face the prospect of having personal liability imposed on them by the courts in respect to the debts of the company.

The hope is that the enactment of a robust Insolvent Trading regime will contribute materially towards the improvement of corporate governance in Hong Kong.

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