A Guide to Schemes of Arrangement in Hong Kong

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The Scheme of Arrangement process can be somewhat cumbersome and expensive. However, in the absence of a formal corporate rescue procedure, in practical terms it is the only tool currently available to facilitate the rescue and restructuring of distressed companies in Hong Kong.

The regulatory structure covering Schemes of Arrangement is set out in sections 669–675 of the Companies Ordinance. The legislation is very similar to that which has operated in the United Kingdom for a number of years and consequently much case law is equally applicable to both jurisdictions. Indeed there are examples of cases in the United Kingdom where passages from judgments in Hong Kong have been favourably quoted.

The Process

The process starts when a company in financial difficulties, with the assistance of its professional advisors (usually its solicitors and an insolvency practitioner), puts together a proposal to be presented to the company's creditors and shareholders. The proposal will usually seek to compromise the company's debts, more often than not with a view to allowing the business to continue operating, often under new ownership. A compromise usually means creditors being prepared to accept less than the amount they are owed in full and final settlement of any claims they may have against the company.

Often the alternative to a Scheme is the liquidation of the company, in which case it is likely that the return will be significantly less (in fact, in many cases there may be no return whatsoever from a liquidation) than would be the case if a Scheme is accepted.

The process is however substantially driven by the Court, particularly in its early stages, and has significant cost implications. Therefore, in practical terms, in most cases, a company needs to be of a certain critical mass before it is cost effective to consider a Scheme. Once a proposal has been formulated by the company and its professional advisors, it must then be presented to the shareholders and creditors. However, before this can be done, it is necessary to obtain the agreement of the Court to meetings of the respective classes of creditors and shareholders being convened.

Why Schemes Are Used In Hong Kong To Rescue Distressed Companies

In Hong Kong there is no formal insolvency process to provide a moratorium to protect a financially distressed company against its creditors whilst efforts are made to restructure it. Attempts have been made to introduce such a system, most notably the recent laudable but nonetheless so far unsuccessful attempts to introduce Provisional Supervision.

However, the fact remains that if a company is in financial difficulties and it wishes to seek protection from its creditors, no formal procedure exists other than provisional liquidation, to facilitate the rescue of parts or the whole of an ailing business.

Schemes have been used in a wide variety of situations including to rescue numerous listed companies during the last 15 years. However, the use of Schemes to rescue failing listed companies has been rendered much more problematic since 2018 when the Hong Kong Exchanges and Clearing tightened the delisting regime. Now a listed company could be delisted if the trading of its shares has been suspended for 12 months and the listed company is unable to present a viable restructuring plan to satisfy the resumption requirements.

Schemes have also been used to rescue or restructure private companies and in particular those in the construction industry that have government licences.

Explanatary Statement

This sets out the background to the company's affairs explaining the reasons for the difficulties faced by the company. It will contain statutory information relating to the company, its background and its accounting history. More importantly it will focus on the company's proposals for resolving its financial difficulties, including any change in the control of the company that may come about as a result of the acceptance of the Scheme.

The document will also set out the terms and conditions governing the operation of the Scheme, classes of creditors, issues relating to the meetings of creditors and shareholders, distributions, etc, – in other words the nuts and bolts of how the Scheme will work.

The effect of the Explanatary Statement is to ensure that, prior to attending at and/or voting on the Scheme, creditors are provided with all the necessary information, in an easily understandable format (or as understandable as it can be), to enable them to make an informed decision on whether to accept or reject the proposal.

The Court will review this document in some detail prior to sanctioning the convening of the meetings. In particular, the Court will be anxious to ensure that the document properly explains the reasons and purposes behind the Scheme and contains all the necessary information and provisions to enable the creditors to make a reasoned decision on the Scheme and for it to proceed if creditors agree.

At the respective meetings, it is necessary for a majority of 75 percent in value and 50 percent in number of those present or represented to approve the proposed scheme. It is important to appreciate that this majority must be achieved at the meeting of every class of creditors and shareholders which is held.

Meetings Of Classes

The issue of classes has been dealt with extensively by both the Courts in Hong Kong and the UK. The crucial issue is to establish whether or not persons within a particular class have similar legal rights against the company. The issue of what constitutes legal rights against the company has been looked at in a number of Hong Kong cases including UDL Argos Engineering and Heavy Industries Company Limited and S Megga Communications Limited.

One of the problems with classes has been that traditionally it is for the advisors to the company to decide upon how the classes are to be constituted in respect of which meetings are to be held. This decision is made before the initial application is made to the Court for sanction to convene the meetings.

This has often resulted in creditors and shareholders in various classes, meeting and approving the Scheme but then at the final hurdle, that is the sanction hearing before the Court, it is decided that the classes have been incorrectly constituted. This was the case in S. Megga. If the classes have not been properly constituted, the Court has no jurisdiction to consider the application further and the Scheme will then automatically fail. That means that there is often a considerable waste of time, effort and costs in bringing a Scheme to fruition.

However, in recent years following a practice direction in the UK, which was tacitly accepted in Hong Kong, in the case of Oxford Properties and Finance Limited, it appears that an application may be made at an early date, that is prior the application to convene the meetings, for the Court to consider whether or not the classes of creditors and shareholders for whom meetings have been called, have been properly constituted. This represents a welcome step forward.

Chairman Of The Meeting

The identity of the chairman of the meeting is set out in the Court order convening the meeting. Sometimes it will be a director of the company, but if a provisional liquidator has been appointed, then he will be the chairman of the meeting. His role is to properly conduct the meeting and then report the outcome of the meeting to the Court.

The main issue which he has to address is that of the valuation of creditors' claims for the purposes of voting at the meeting. In this respect, he has to be particularly careful. Any misstep at this time could be raised subsequently at the sanction hearing and, in certain circumstances, could result in the Court rejecting a Scheme which has been accepted by the creditors and shareholders at the respective meetings.

Assuming that the necessary majorities are achieved at the respective meetings of the different classes of creditors and shareholders, it is then necessary for the chairman of the meeting to report to the Court on the outcome of the various meetings. A further hearing, known as the Sanction Hearing, is then held, at which the Court will give its final approval, or sometimes not, to the Scheme being implemented.

The Sanction Hearing

The sanction hearing is not a rubber stamp. The Court will consider whether or not the necessary statutory requirements have been satisfied and in particular whether or not classes of creditors have being properly constituted, always assuming of course that this issue has not previously been addressed. It will need to be satisfied that each class has been fairly represented and has voted bona fide in the genuine interests of the class and that there has been no coercion for members of a particular class to vote in a particular way. The Court will also want to be satisfied that the Scheme as proposed and accepted by creditors is fair and reasonable in the circumstances and that there were no irregularities at the meeting.

The final approval of the Scheme is achieved when the Court order arising from the Sanction Hearing is filed with the Registrar of Companies. The role of the scheme administrator is then to implement the provisions of the Scheme. Once the Scheme has been implemented and completed he will then file a notice with the Registrar of Companies stating that the Scheme has been concluded.

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BW
BRISCOE • WONG
ADVISORY

Room 818, 8/F. China United Centre,
28 Marble Road,
North Point, Hong Kong

t: 852 3198 0800
f: 852 2719 4622
enquiries@briscoewong.com