Recent Developments in Corporate and Cross-Border Insolvency Law in Hong Kong

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Unlike most other jurisdictions in Asia, Hong Kong began its insolvency law reform efforts in 1990, independent of the Asian financial crisis. Nevertheless, Hong Kong has yet to enact an effective statutory corporate rescue procedure. This article discusses the Hong Kong government’s corporate rescue proposals currently under consideration, the recent developments in using provisional liquidation to facilitate corporate rescue in Hong Kong, and the recommendations of the Hong Kong Law Reform Commission to reform the law relating to cross-border insolvency.

Introduction

On July 1, 1997, the British colony of Hong Kong became a Special Administrative Region of the People’s Republic of China. The “one country, two systems” approach is embedded in the Basic Law (Hong Kong’s new constitution). Article 8 provides that the laws previously in force in Hong Kong – ordinances, subordinate legislation, the common law, rules of equity, and customary law – continue to apply after the transition, except to the extent that they contravene the Basic Law or are amended by the legislature of the Hong Kong Special Administrative Region.

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Insolvency law reform efforts in Hong Kong began in 1990 when the Law Reform Commission of Hong Kong appointed the Sub-Committee on Insolvency. The Sub-Committee commenced work on November 12, 1990 and issued three consultative documents: one on personal bankruptcy (and voluntary arrangements) (1993), another on corporate rescue and insolvent trading (1995), and the third on corporate liquidation (1998). After consultation among interested professional bodies and others, each of these consultative documents was followed by a report of the Law Reform Commission, on bankruptcy (1995), on corporate rescue and insolvent trading (1996), and on corporate liquidation (1999). However, the only area of the law that has actually been amended is bankruptcy. The Bankruptcy (Amendment) Ordinance 1996 came into operation on July 1, 1998.

Provisional Supervision

The most contentious area of law reform has involved corporate rescue, in great part because of opposition to many aspects of the government’s proposals that differed from the earlier recommendations by both the Sub-
Committee on Insolvency and the Law Reform Commission of Hong Kong. The government’s second bill proposing a corporate rescue procedure, called “provisional supervision”, was gazetted in May 2001 as the Companies (Corporate Rescue) Bill 2001 (the “2001 Bill”), but has again run into difficulty because of its approach to resolving the issue of workers’ rights (discussed below).

The absence of an effective formal corporate insolvency regime is the most striking defect in Hong Kong’s insolvency regime. To address this problem, in April 1998 the Hong Kong Association of Banks issued guidelines for corporate restructuring in multi-bank situations, which are based on the well-known London Approach. In 1999, these guidelines were revised and extended in the form of joint guidelines issued by the Hong Kong Association of Banks and the Hong Kong Monetary Authority, and are known as the “Hong Kong Approach to Corporate Difficulties”.

At present, the only available statutory mechanism in Hong Kong to enable a company in financial distress to restructure is a scheme of arrangement pursuant to section 166 of the Companies Ordinance (a replica of the U.K. scheme of arrangement procedure). Complaints are frequently raised about the section 166 procedures when used in relation to a corporate rescue (for which it was not specifically designed), including that schemes of arrangement tend to be complex, highly technical, require too many court hearings and, unless conducted when a company is in provisional liquidation, do not benefit from a moratorium. In addition, there is no mechanism under section 166 for forcing unwilling secured creditors to come to the table to negotiate.

In 1996, when the Law Reform Commission put forward its plans for the new provisional supervision regime, it was intended that provisional supervision would be a streamlined procedure with minimal

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12 Hong Kong Companies Ordinance, cap 32, L.H.K., sec. 166.
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court involvement, but with the crucial advantage of a moratorium. Unlike the usual rules applicable in Hong Kong corporate liquidations, the moratorium would also apply to secured creditors.  

Under the proposed scheme, a company would be able, without going to court, to 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. Each “major secured creditor” – defined as “the holder of a charge, whether fixed or otherwise, over the whole or substantially the whole of the company’s property” – is given a veto power over whether the provisional supervision should go forward. Once a major secured creditor consents to provisional supervision, it is also bound by the moratorium.  

Where the provisional supervision goes forward, a rescue proposal will be proposed to the creditors in due course. Approval requires passage by a majority vote in number and of two-thirds in value of the creditors present and voting in one single class. (By contrast, to approve a scheme of arrangement, creditors will often be divided into several classes and the scheme must receive the approval of a majority in number and three-quarters in value of each class of creditors, present and voting.) To facilitate a provisional supervisor’s attempts to rescue a company, the 2001 Bill (on the recommendation of the Law Reform Commission) includes super-priority funding, so that where funds are provided as working capital by a lender after commencement of the provisional supervision, such debt would be given priority over all other debts (except for a fixed charge).  

The recommendations of the Law Reform Commission were first put forward in bill form in January 2000 in the Companies (Amendment) Bill 2000 (the “2000 Bill”). This bill, however, came under heavy criticism
for a number of its proposals. The issue that attracted the most public debate was the way in which the bill dealt with wage and other claims owed to a company’s workers. It proposed that a company would have to either 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 Law Reform Commission had initially proposed. The Commission had hoped that the Protection of Wages on Insolvency Fund (the “PWIF”), which is currently available only when a company goes into compulsory liquidation, would be extended to cases of provisional supervision.

The obvious question in relation to the 2000 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 on the utility of provisional supervision. Unfortunately, however, the 2001 Bill does not improve upon this position. The latest bill provides that 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, the term “former employees” is widely defined. It includes not only workers who have already been laid off, but also workers whose employment will be terminated on or after commencement

20 The government objected to using the PWIF for provisional supervision, for fear that the fund would become a resource for corporate bailouts and eventually go bust. Ironically, the fund became insolvent anyway, and in October 2002 was rescued with the commitment by the Hong Kong government to extend to the PWIF a HK$695 million bridging loan between 2002-2003 and 2005-2006.
22 See Companies (Corporate Rescue) Bill 2001, supra n. 10, schedule 2, para. 3(d).
of the provisional supervision. For example, if a company intends to go into provisional supervision and then lays 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 2001 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 Hong Kong government.

Finally, it appears that a possible compromise is in the offing. In December 2001, the Bills Committee of the Legislative Council suspended its deliberations on the 2001 Bill pending further consultations. In September 2002, the Secretary for Financial Services and the Treasury circulated a Consultation Paper on Proposals Relating to the Trust Account Arrangement under the Companies (Corporate Rescue) Bill (the “Consultation Paper”). The consultation period ended on November 8, 2003. The Consultation Paper proposes that instead of a company having to pay off its workers in full in advance (or having to set up a trust account in that amount), a limit or ceiling will be put on the amount that will have to be set aside by the company (or put in the trust account) before the company may go into provisional supervision. This limit would be calculated by reference to the amounts currently payable by the PWIF when a company goes into compulsory liquidation – for example, the overall cap for workers whose employment is terminated before the corporate rescue procedure starts would be HK$278,500 (roughly US$36,000).

In theory, the 2001 Bill should have several advantages over the guidelines set by the Hong Kong Association of Banks and the Hong Kong Monetary Authority. The new bill applies to all creditors, not just banks,

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23 Id.
25 Up to HK$36,000 for wages for services rendered within four months prior to the last day of service; up to HK$22,500 or one month’s wages, whichever is the lesser, for wages in lieu of notice; and up to HK$220,000 for severance payment, for a total of HK$278,500).
26 See supra n. 11.
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 major secured creditor, it has a veto). (In contrast, the recent Hong Kong Court of Appeal decision *Credit Lyonnais v SK Global Hong Kong Ltd.* discusses the non-binding nature of the Hong Kong Approach to Corporate Difficulties.) In practice, however, it is likely that lenders, as well as companies themselves, will continue to favor an informal workout wherever possible. The appointment of a provisional supervisor – an independent third party supposedly looking after the interests 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: the perceived concern 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 like the provisional supervisor will be significantly less than the costs incurred in an informal workout.

It would be best for Hong Kong if the provisional supervision legislation were introduced as soon as possible (“better late than never”), ideally after the Hong Kong government adopts the proposed cap on payments. A year ago, legal pundits were betting against the enactment of the new law; now it appears that the mood may be gradually shifting in favor of enactment. In any case, even if the legislation is enacted, it would perhaps be unrealistic to expect provisional supervision to have a major or immediate impact upon the number of successful corporate rescues and restructurings in Hong Kong. Large companies, which already have their own professional advisers, will continue to favor 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 put a provisional supervisor in place before things are already

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[27] [2003] HKCA 250. *Credit Lyonnais v SK Global Hong Kong Ltd.* and other Hong Kong cases, *infra*, may be found at http://www.hklii.org/.
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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.

Provisional Liquidation

Another recent development relating to corporate rescue is that the Hong Kong judiciary has recently shown creativity and flexibility in using provisional liquidation procedures to facilitate corporate rescue. Provisional liquidation is normally an interim period during which the assets of a company are protected while the court considers the merits of making a winding-up order. However, in Re Keyview Technology (BVI) Ltd. (“Keyview”),28 the provisional liquidators secured the agreement of all of the company’s creditors to a restructuring proposal and then applied to the court for an extension of their normal powers and for permission to participate in the restructuring. The Hong Kong court held that it had the power to extend the provisional liquidators’ powers and made the requested order.29

Since Keyview, the number of provisional liquidations in Hong Kong being used as a means of corporate rescue has dramatically increased. Moreover, the holding of Keyview has been extended by the courts in Luen Cheong Tai International Holdings Ltd.,30 Re I-China Holdings Ltd.,31 and Re Fujian Group Ltd.,32 which all have recognized “the facilitation of corporate rescue as a rationale for appointing provisional

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29 For further discussion of provisional liquidation, see Hong Kong Corporate Insolvency Manual 143-44 (Philip Smart, Charles D. Booth, & Stephen Briscoe, eds., H.K.S.A. 2002).
liquidators in the first place.” Other recent cases in which provisional liquidation has been used to assist in a corporate rescue include Re Jinro (HK) International Ltd. and the recent application by SK Global Hong Kong Ltd. to prevent a creditor from levying execution against the company’s assets.

It is clear that provisional liquidation provides important benefits to parties trying to restructure a debtor. It puts a moratorium in place and also enables some benefit to be gained from valuable corporate assets, such as the listing status of a company. The Hong Kong courts’ liberal approach to this new use of provisional liquidation has led to the creation of a more formal corporate rescue mechanism that can be utilized when an out-of-court workout proves to be impossible.

Cross-Border Insolvency Law

The Hong Kong Law Reform Commission’s recommendations regarding cross-border insolvency were contained in chapter 26 of the 1999 report covering corporate liquidation. At present, the relevant Hong Kong provisions are included in part X of the Hong Kong Companies Ordinance (cap 32), which applies to unregistered companies (which, in turn, includes foreign companies). However, many of the relevant issues – such as the necessary jurisdictional connection between the foreign debtor and the foreign jurisdiction, the necessary connection between the foreign debtor and Hong Kong, and the ability of a foreign representative to commence an insolvency proceeding in Hong Kong – are not covered by the statutory regime, but are, rather, left to interpretation through case law. Some commentators had hoped that the law reform process would lead to codification (and resolution) of many of these important issues. However, the Law Reform Commission has instead decided to leave the issues to the courts for determination.

34 The application was made in response to the decision noted in supra n. 27.
35 See supra n 8.
At present, cross-border insolvency issues may be handled under a universality/plurality approach in which a full liquidation may be commenced in Hong Kong and provide “ancillary” assistance (used in its British, and not U.S., sense; local, Hong Kong law will be applied). At the time of drafting its recommendations, the Hong Kong Law Reform Commission could have been in the vanguard in recommending adoption of the UNCITRAL model law, but it shied away from the opportunity and instead recommended that Hong Kong enact the equivalent of section 304 of the U.S. Bankruptcy Code – so that the foreign representative would not need to commence full insolvency proceedings under the Companies Ordinance as is now the case – with the exception that recognition should be given on a bilateral basis. In other words, the current recommendation is the adoption of a U.S.-style 304 ancillary proceeding, but one that (unlike the United States) includes a reciprocity requirement. Under the Law Reform Commission’s recommendations, Hong Kong courts would have the discretion to apply foreign law in the Hong Kong proceedings.37

A further issue relating to cross-border insolvency law is that one of the unintended consequences of the bankruptcy law reforms contained in the Bankruptcy (Amendment) Ordinance 1996 is that the unfair preference avoidance provisions applicable in liquidations now arguably apply extraterritorially.38

Conclusion

Next year might well be the year in which provisional supervision is finally enacted into law in Hong Kong. If that does occur, it will be interesting to see to what extent the new procedure is able to make inroads into the increasing use of provisional liquidation in Hong Kong. In any case, once the Hong Kong legislature concludes its deliberations on provisional supervision, attention can then turn to the recommendations contained in the 1999 Law Reform Commission Report focusing on

37 For further discussion of Hong Kong cross-border insolvency law, see id. and Charles D. Booth, Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law, 34 Colum. J. Transnatl. L. 389 (1996).
corporate liquidation.39 Among the issues to be considered at that time will be whether the Commission’s recommendations regarding cross-border insolvency should be enacted into law.40

39 See supra n. 8.

40 Mr. Booth gratefully acknowledges the support provided by the Hong Kong Research Grants Council through its funding of a research project entitled "Moving from a Planned Economy to a Market Economy: The Development of a New Insolvency System in Mainland China and its Cross-Border Impact" (Ref: HKU 7167/01H), of which Mr. Booth is the Principal Investigator.