THE LAW REFORM COMMISSION OF HONG KONG

SUB-COMMITTEE ON INSOLVENCY

CONSULTATION PAPER

CORPORATE RESCUE AND INSOLVENT TRADING

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June 1995

This Consultation Paper is circulated for comment and criticism only. It does not represent the views of the Law Reform Commission.

The Commission's Sub-committee on Insolvency would be grateful for comments on this Consultation Paper **by 31 August 1995.** All correspondence should be addressed to:

The Secretary,
The Insolvency Sub-committee,
The Law Reform Commission,
20/F Harcourt House,
39 Gloucester Road,
Wanchai,
Hong Kong.

It may be helpful for the Commission, either in discussion with others or in any subsequent report, to be able to refer to and attribute comments submitted in response to this Consultation Paper. Any request to treat all or part of a response in confidence will, of course, be respected, but if no such request is made, the Commission will assume that the response is not intended to be confidential.

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CONTENTS

Introduction

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1. The Law Reform Commission of Hong Kong was established by the Governor-in-Council in January 1980. The Commission reports on such matters as the Attorney General or the Chief Justice refers to it.

Terms of reference

2. On 14th September 1990, the Attorney General and the Chief Justice referred the following topic to the Commission :

> *"(1) To review the law and practice relating to the insolvency of both individuals and bodies corporate in Hong Kong, and in particular:*
>
> *(a) the provisions of the Bankruptcy Ordinance, Chapter 6, in their application both to business and non-business debtors; and*
>
> *(b) the winding-up provisions of the Companies Ordinance, Chapter 32*
>
> *taking into account existing and proposed legislation in other jurisdictions, in particular the UK Insolvency Act 1986 and Chapter 11 of the U.S. Bankruptcy Code, and to consider what reforms are necessary or desirable.*
>
> *(2) To submit an early interim report on.*
>
> *(a) such changes in the Bankruptcy Ordinance as are considered to be required for simplifying bankruptcy procedures, and*
>
> *(b) any other aspects of insolvency law or practice which the Commission considers should be introduced in advance of the Commission's final report."*

3. The Commission's Report on Bankruptcy was published in May 1995.

4. The sub-committee is chaired by Professor Edward L.G. Tyler, formerly a Judge of the District Court and Professor and Head of the Department of Professional Legal Education at the University of Hong Kong,

and now Professor and Head of the Department of Legal Education at the City University of Hong Kong. Professor Tyler was a member of the Law Reform Commission from 4th July 1987 to 11th August 1993. The other members of the sub-committee are:

Mr Mark Bradley	Solicitor, Deacons
Mr Graham Cheng OBE JP	Chairman, Taching Petroleum Co Ltd
Mr Nicholas, Etches	Accountant, KPMG Peat Marwick
Mr Stefan Gannon	General Counsel to the Hong Kong Monetary Authority
Mr David Hague	Accountant, Price Waterhouse
Mr Robin Hearder JP	Official Receiver
Ms Barbara Martin	Solicitor, Carey & Lui
Mr Michael Page (until 30.3.1994)	Senior Executive Hong Kong & Shanghai Banking Corporation Ltd
Mr David Tam Wai-hung (since 25.4.1994)	Senior Executive, Corporate and Institutional Banking, Hong Kong & Shanghai Banking Corporation Ltd
Mr Winston Poon	Barrister
Mr Ian Robinson	Accountant, formerly of Ernst & Young, now a director of Robinson Management Limited

5. Mr Jeremy Glen, Senior Crown Counsel acted as the Secretary to the sub-committee.

6. The terms of reference provide that the sub-committee may make an interim report on such other aspects of insolvency law or practice which the Commission considers should be introduced in advance of the Commission's final report on insolvency. The sub-committee's intention had been to make a single interim report on bankruptcy to the Commission followed by a final report on all other aspects of personal and corporate insolvency.

7. Insolvency practitioners on the sub-committee, however, pointed out that provisions of the Companies Ordinance relating to arrangements and reconstructions were inadequate and called for a second interim report on corporate rescue in advance of the final report. It was argued that Hong Kong needed a comprehensive system to enable and encourage the reorganisation of companies in situations where liquidation was not the appropriate solution. These members were in no doubt that the current provisions are so difficult to operate under that there have been very few successful workouts achieved under section 166, the relevant section.

8. The sub-committee accepts that the present Companies Ordinance provisions on arrangements and reconstructions are not capable of providing the legislative and procedural support required to propose and formulate a voluntary arrangement and therefore decided to give priority to consideration of a scheme for corporate rescue.

9. This Consultation Paper sets out the sub-committee's proposals for a corporate rescue procedure, which we refer to as provisional supervision. In addition, we propose that directors and senior management of companies may be made liable for the losses of a company which traded while insolvent. This paper is published with the purpose of stimulating comment on the proposals from interested parties both in Hong Kong and internationally.

10. The call for a corporate rescue procedure comes at a time when Hong Kong is enjoying economic growth. There is no pressure to introduce a procedure brought on by the consequences of recession as perhaps has been the case in some other jurisdictions where similar provisions have been introduced.

11. We have used a model Bill[1] for provisional supervision and insolvent trading, drafted by our Chairman, which we found useful in drawing the provisions together and ironing out contradictions. The model Bill went through several redrafts before reaching its present state and is reproduced in the annexure. It is intended to facilitate understanding of the proposals. It is not intended to be anything other than an aid and we acknowledge that legislative drafting is the province of the Law Draftsman.

12. We would note that, while many aspects of procedure are addressed in the Consultation Paper, and in particular in the model Bill, we have not referred to all the supporting rules when we have based proposals on existing legislation in other jurisdictions. We wish to emphasise that it is our general intention that the relevant supporting rules would be adopted in respect of each proposal that draws on existing provisions.

13. It should be noted that this paper is published by the Commission's sub-committee on insolvency and is not a report of the Commission.

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[1] All references and footnotes to sections, which are not attributed to legislation in the text above the footnote means the footnote refers to sections of the model Bill set out in the Appendix.

Acknowledgements

14. In the course of our considerations we had the benefit of meeting, on separate occasions, with Colin Bird, Head of Corporate Recovery at Price Waterhouse United Kingdom and Chairman of the Technical Committee of the Society of Insolvency Practitioners, Professor Jacob Ziegel of the Faculty of Law, University of Toronto, Canada and with Dr W J Gough, a partner with Goughs, Solicitors, of Sydney, Australia, all of whom offered valuable insights into the procedures in place in their jurisdictions and their views on how corporate rescue might best be achieved. We wish to thank Mr Bird, Professor Ziegel and Dr Gough for giving so freely of their time. We particularly acknowledge the use we have made of a paper prepared by Dr Gough[2] which set out an illustration draft Bill for a company rescue procedure. The draft Bill provided the inspiration for the Chairman's model Bill reproduced in the annexure.

Abbreviations

15. For the sake of brevity, when we refer to "he" we mean "he and she" unless the context implies otherwise. For the sake of conciseness, we have used abbreviated forms in respect of the following reports and legislation.

"The Cork Report"

The Report of the United Kingdom Committee on Insolvency Law and Practice under the Chairmanship of Sir Kenneth Cork.[3]

"The Harmer Report"

General Insolvency Inquiry: a Report of the Law Reform Commission of Australia under the Chairmanship of Mr Ron Harmer.[4]

"The Insolvency Act"

This refers to the United Kingdom Insolvency Act 1986.

"The Insolvency Rules"

This refers to the United Kingdom Insolvency Rules 1986.

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2 Insolvency Administration Reform : The Recent Australian Model or Something Better? April 1993.

3 1982. Cmnd 8558.

4 Report No. 45, September 1988.

"The model Bill"

This refers to our working model Bill, referred to in paragraph 11 above.

Chapter 1

Provisional supervision

The present position

1.1 At present, Hong Kong companies that get into financial difficulties may try to come to an arrangement with their creditors by means of some non-statutory arrangement or by means of the arrangements and reconstructions provisions of the Companies Ordinance. The relevant provision is section 166 which provides that:

> *"(1) Where a compromise or arrangement is proposed between a company and its creditors or any class of them, or between the company and its members and any class of them, the court may, on the application in a summary way of the company or of any creditor or member of the company, or, in the case of a company being wound up, of the liquidator, order a meeting of the creditors or class of creditors, or of the members of the company or class of members, as the case may be, to be summoned in such manner as the court directs.*
>
> *(2) If a majority in number representing three-fourths in value of the creditors or class of creditors, or members or class of members, as the case may be, present and voting either in person or by proxy at the meeting, agree to any compromise or arrangement, the compromise or arrangement shall, if sanctioned by the court, be binding on all creditors or the class of creditors, or on the members or the class of members, as the case may be, and also on the company or, in the case of a company on the course of being wound up, on the liquidator and contributories of the company.*
>
> *(3) An order made under subsection (2) shall have no effect until an office copy of the order has been delivered to the Registrar for registration, and a copy of every such order shall be annexed to every copy of the memorandum of the company issued after the order has been made, or, in the case of a company not having a memorandum, of every copy so issued of the instrument constituting or defining the constitution of the company.*
>
> *(4) If the company makes default in complying with subsection (3), the company and every officer of the*

company who is in default shall be liable to a fine for each copy in respect of which default is made.

(5) In this section and in section 166(A), the expression "company" means any company liable to be wound up under this Ordinance, and the expression "arrangement" includes a re-organisation of the share capital of the company by the consolidation of shares of different classes or by the division of shares into shares of different classes or by both these methods."

1.2 The major deficiency with section 166 is the lack of a moratorium that can bind creditors while an arrangement plan is being formulated. There is nothing in section 166 which prevents a creditor presenting a petition to wind up the company, an event which could have the effect of ending the formulation of any proposal. There is no comparison to be made between section 166 and the sophisticated corporate rescue procedures operating in jurisdictions such as the United Kingdom, Australia, Canada and the United States of America. Section 166 is so clearly deficient in the elements required for a proposal to creditors to be made that it did not assist in any way in the formulation of our proposals. There are no figures available on the number of successful, near insolvency, arrangements under section 166 but, to the best of our knowledge, the number of arrangements involving companies of any size over the last ten years are relatively few.

1.3 It is not our intention, however, to replace section 166 with our proposals. We see a place for section 166, as it might be considered suitable for use in some insolvency situations. The availability of more than one procedure is not unique, as evidenced for example by the company voluntary arrangement and administration procedures under the Insolvency Act 1986 and by the procedures available under the Canadian Companies' Creditors Arrangement Act and the Bankruptcy and Insolvency Act. In this context, it is worth considering amending section 166 to provide for a moratorium where a company is insolvent. In addition, section 166 might still be used in circumstances where the proposed procedure is terminated without a voluntary arrangement having been achieved, though this is unlikely to happen as there is extensive provision made for the procedure to be extended at the behest of creditors.[5]

Significant insolvency cases in Hong Kong

1.4 In the early to mid 1980's Hong Kong suffered a rash of insolvencies involving large commercial bodies. The worst period was between 1983 to 1985 when three banks, the Hang Lung Bank, Overseas Trust Bank and Hong Kong Industrial and Commercial Bank were taken over by the Government, and publicly listed electronics manufacturer, Atlas Industries, the retail Millie's Group and the Carrian Group conglomerate, went

[5] See paragraph 15.12.

into liquidation. In 1986, the Klasse Department store chain, which had eight outlets in Hong Kong, went into liquidation. The Da Da department stores chain, and its parent company, Cranes Stores Ltd, also went under that year, following the failure of a debt restructuring scheme which had been set up after the company went into receivership in July 1985. A newspaper article at the time reported the receiver of the Da Da chain as saying that the company could have been saved from liquidation if it had been given time and patience by the banks and creditors.[6]

1.5 The same article noted that there had been some successful receiverships, including Database Asia Ltd, which was sold to a local investment group, and Koyoda Electronics Ltd, which, after being sold, was turned into a successful operation. The only successful court approved scheme of arrangement under section 166 involved the restructuring of the Associated Hotels Group in October 1985. The scheme of arrangement took about two and an half years to complete.[7]

1.6 Another successful restructuring, which did not use section 166, involved the family run Fung Ping Fan group of companies. The Fung group's restructuring was completed in November 1987 after a petition for winding up was filed in about December 1986. A newspaper article at the time reported that its two major bank creditors, believed to be owed at least $200 million, supported the restructuring.[8]

1.7 The most dramatic and illuminating rescues, however, concerned two shipping firms, the C.H. Tung Group and the Wah Kwong Group, both of which got into difficulties in 1986 and were restructured during 1987. Both companies are now successful, with the public trading arm of the C.H. Tung Group, Oriental Overseas (Holdings) Ltd (OOHL), recently reported to be have placed orders for six container ships, valued at over US$500 million.[9] The company reported a profit of more than $1 billion in March 1994 on a turnover of more than $10 billion. It is the sixth biggest company in Hong Kong. The C.H. Tung Group debts were estimated to amount to US$2.6 billion with the Wah Kwong Shipping Group debt estimated at about US$850 million.

1.8 The events surrounding the restructurings of both companies were remarkably similar. Both companies were large groups, in the same business, both family run, both got into difficulties during a world-wide shipping slump, both had support from their largest creditors, in both cases the creditors were from many different countries and both had smaller creditors that wanted to be bought out and who delayed the process. The two groups arguably fell into the "too big to go bust" category of companies.

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6 "More opt for restructuring to stay afloat", South China Morning Post, 21st December 1986.

7 Associated Hotels is now known as Tian Teck Land, winch is a company listed on the Stock Exchange of Hong Kong.

8 South China Morning Post, 16th March 1987.

9 South China Morning Post, 8th March 1994.

Other jurisdictions

1.9 We have had the benefit of the experience of several reporting committees and of the operation of systems for corporate rescue in various jurisdictions. Most notably, we have drawn on the experience in the United Kingdom and its Law Commission's report, under the Chairmanship of Sir Kenneth Cork, commonly referred to as "the Cork Report" [10] and the experience of the company voluntary arrangement and administration procedures under the Insolvency Act 1986.

1.10 We considered the "Harmer Report" [11], the result of the Australian Law Reform Commission's General Insolvency Inquiry under the Chairmanship of Mr Ron Harmer, and the recent Australian provisions on administration of a company's affairs with a view to executing a deed of company arrangement [12]. We also considered the recently introduced Canadian provisions for a general scheme for proposals. [13] Both the Australian and Canadian provisions provide innovative solutions for problems that occur in corporate rescue culture and elements of both sets of legislation appear in our proposals.

1.11 We also looked at Chapter 11 of the United States Bankruptcy Code and, while not adopting the Chapter 11 concept of debtor in possession, we believe that the directors of a company should, where possible, remain involved in the management of the company during the proposal period and, depending on the terms of the proposal, beyond. We do not believe, however, that the concept of the debtor in possession, in other words the existing management, would be acceptable to creditors in Hong Kong and our proposals reflect this in providing for an outside party, to be known as the provisional supervisor, to take effective control of the company during the proposal period, to be known as the provisional supervision period.

1.12 Neither the Canadian nor the Australian procedures have yet had time to build up a significant body of statistics to indicate whether they may be considered a success, though the early signs from both jurisdictions are encouraging.

1.13 We also considered the provisions on judicial management in Singapore which follows the Insolvency Act 1986 to a significant extent, and the provisions on examinership in Ireland.[14]

1.14 Some of the procedures in other jurisdictions are being reviewed. In the United Kingdom, the Insolvency Service has issued a Consultative Document on the Insolvency Act's company voluntary arrangement and

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10 "Insolvency Law and Practice"; Report of the Review Committee; United Kingdom, June 1982. Cmnd 8558.

11 Report No. 45, September 1988.

12 Corporate Law Reform Act 1992.

13 Bankruptcy and Insolvency Act 1992, Part III.

14 The Companies (Amendment) Act 1990.

administration procedures.[15] In the United States, Chapter 11 is being reconsidered as is the comparatively recent Irish procedure.

1.15 Legislating for comprehensive corporate rescue procedures is still at a relatively early stage and we consider that we are participating in an international learning process. We have no illusions that our proposals are a perfect solution and we welcome critical submissions not only from Hong Kong but from abroad.

Benefits of provisional supervision

1.16 We considered whether a crude, though effective, reorganisation process already operates in the demise of businesses or industries and their replacement by new businesses or new industries. We asked whether Hong Kong needs a formal procedure for restructuring that is better than the existing situation which, it may be argued, allows businesses to decline and die and encourages the development and growth of new businesses.

1.17 We believe that this process of decline and growth would continue in any event and that there is a place for a corporate rescue procedure which would complement the existing procedures provided it was used in cases where a company or part of a company could be saved.

1.18 In our view, it is beyond dispute that it is better for a viable business to survive as a going concern, in whole or in part, than for it to be simply wound up and such assets as remain distributed. It benefits the company's shareholders, as if the company survives, their shareholdings might become valuable, whereas if a company is insolvent and wound up they get nothing. It benefits the ordinary creditors of the company if they obtain more from a company reorganisation than from a dividend in a winding up, with the added benefit that they would keep a customer. It has become increasingly clear that secured creditors, usually banks, must look beyond the notion that being secured means that they are not affected by the winding up of a client company. Employment that would otherwise disappear would be preserved, at least to some extent. All of this has implications for Government both in revenue and social terms.

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15 The Insolvency Act 1986 : Company Voluntary Arrangements and Administration Orders, A Consultative Document. October 1993. It has been reported recently that the British Government has proposed what is described as a "radical new procedure" in which directors of an enterprise on the verge of collapse would be given a 28 day moratorium to put together a rescue plan. During the moratorium the directors would be supervised by an insolvency practitioner. The proposal is specifically designed for small businesses with cashflow problems which tend to be destroyed by a scramble for assets once their troubles become known to creditors. The proposal reflects a broad consensus that there should be a short moratorium available to provide breathing space. The scheme, however cannot be set up until the insolvency practitioner is satisfied that there is a "reasonable prospect" of success. A creditors' meeting would be held within 28 days of the start of the moratorium and if more than 75 % of creditors in value supported the proposal it would be binding. Financial Times, 6th April 1995, page 9.

(a) the company

1.19 The advantage for a company and its shareholders is plain. If it can achieve a voluntary arrangement under supervision, there are good prospects that it can return to profitability. This is attractive to the shareholders, who generally have the lowest priority when it comes to the distribution of the assets of a company that has gone into liquidation, and who might otherwise be unlikely to get anything from a winding up.[16]

(b) employees

1.20 For employees, the preservation of their jobs is of the utmost importance. For older workers, accumulated pension rights might be at risk, and it would probably be difficult to find new employment at the same remuneration, if at all. Younger workers have families to support, mortgages to service or rent to pay. The greatest numbers of jobs are lost in times of recession when a job lost is not easy to replace. Successful workouts in times of recession take on a greater significance than may be apparent in a booming economy.[17]

(c) unsecured creditors

1.21 Unsecured creditors are often considered to have a raw deal in a liquidation. By the time the preferential creditors have been paid and the secured creditors have taken their entitlement out of a company, unsecured creditors often find that they receive no dividend and, even in cases where there is a dividend they have to wait several years, on average, for payment. Preferential creditors, including employees, are in a better position but even for them the statistics show that liquidation is not a cause for celebration.[18]

(d) secured creditors

1.22 Why then should secured creditors have any interest in entering into a voluntary arrangement? On the face of it, they have security and the ability to realise it by appointing a receiver under the debenture. The reality, however, is that it is not unusual for there to be multiple secured creditors with varying securities and priorities over the assets of a company. Because of the

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16 In 1993/94, the Official Receiver made payments to creditors and returns of capital to shareholders of just over $218 million, in compulsory liquidations. Of that, $2,577,000, or less than 1.2% was returned to shareholders. Source: Official Receiver's Office, Annual Department Report 1993-94, annex 14, page 3.

17 The Official Receiver's Office reports that in 1991/92 it took an average of 4.00 years to pay an average rate of 58.54% first and final dividend to preferential creditors; in 1992/93 the average time was 3.30 years to pay an average dividend of 71.97%; and in 1993/94 the average time was 2.85 years to pay an average dividend of 63.37 %.

18 The Official Receiver's Office reports that in 1991/92 it took an average time of 5.99 years to pay an average rate of 18.89% first and final dividend to ordinary creditors; in 1992/93 the average time was 5.36 years to pay a dividend of 32.45%; and in 1993/94 the average time was 4.51 years to pay a dividend of 38.82%.

nature of floating charges, which permit a company to deal with the assets covered by the floating charge in the ordinary course of business, and also because of what critics would say is the lack of caution of some lenders, the value of a company's assets can diminish, leaving some or all of the secured creditors undersecured. In such a situation, the secured creditors might conclude that a voluntary arrangement was an attractive proposition.

1.23 It goes further than that however. Lenders, usually banks, are in a competitive business and realise that if a client company goes into liquidation they lose any prospect of new business with that company. Even if the gap left by a wound up company is filled by another entity there is no guarantee that the lender will get the new business. If the lender can participate in a provisional supervision leading to a voluntary arrangement under supervision, the lender can retain a client which it understands much better and with which it can do business in the future.

1.24 In the greater scheme of business lending therefore, it is in the general interest of lenders to promote and participate in a rescue culture. This is evidenced by the development in the United Kingdom of what is known as the London (Bankers') Approach. This is a non statutory, informal arrangement whereby a lead bank of lenders seeks to support a company in financial difficulties while a decision on the company's long term future is made. The lenders work together to reach a collective view on whether and on what terms a company should be given a financial lifeline. The Bank of England has a role in this as it is prepared to offer help in negotiations. If called upon to do so and, in any event, it is kept advised of progress in major workouts using the approach. It appears that the London Approach is working well and that in recent years there have been comparatively few cases where an attempt to organise a workout has failed because the banks concerned could not agree terms themselves.[19]

1.25 The usefulness of a corporate rescue procedure was recently, graphically, demonstrated in the collapse of Barings Bank, which was an international operation. Barings Bank in the United Kingdom went into administration under the Insolvency Act and was sold off, with the approval of the court, in a very short period of time. If Barings had not had the benefit of the moratorium imposed under the administration procedure, it would have proved more difficult to achieve the sell off as other parties could have taken proceedings and disrupted the negotiations.

The name of the procedure

1.26 The procedure we contemplate, while unashamedly borrowing from other procedures, has its own characteristics and is quite distinct. In order to distinguish it further, as much initially to avoid confusing ourselves as for any other reason, we searched for an appropriate name. We settled on provisional supervision, as the procedure revolves around the person who is

[19] Extracts taken from "Saving Businesses - The London Bankers' Approach" A talk by MTR Smith of the Bank of England to the INSOL Conference in Melbourne; March 1993.

brought in to prepare a proposal and we considered that "provisional supervisor" was the best expression of his or her function. If a proposal was subsequently accepted by creditors a supervisor, who in all probability would be the provisional supervisor, would oversee the voluntary arrangement.

1.27 When we started work on this paper we had no preconceived ideas as to the system that we would adopt. What has developed is basically a procedure for the preparation of a proposal for a voluntary arrangement. To achieve this there must be a moratorium and there must be clear statements as to the purposes of provisional supervision and the powers and functions of the provisional supervisor. Our reasoning is developed in the following chapters, which detail the procedure.

1.28 We saw as our ideal a procedure that was cheap, quick, simple and effective. We have discovered, however, that to be effective any procedure has a cost. The procedure already available under section 166 of the Companies Ordinance has proved to be very expensive to operate. The difficulties involved in a reorganisation are considerable and necessarily involve a certain amount of expense and time. In addition, the need to delineate responsibilities and protect the interests of the various parties means that procedures have to be adopted to provide checks and balances. These four criteria above were, however, uppermost in our minds at all stages of the procedure and we have consciously tried to reduce the chances of a long, involved and expensive process.

1.29 We have tried to keep the procedure within strict time limits by imposing an initial stay of 30 days which may be extended by application to the court. In this, we drew on the new Australian and Canadian provisions. We believe that undue delay acts against the chances of success of a reorganisation. For a long time we were prepared to propose that the moratorium should only last for a maximum of 6 months but in the end we accepted, reluctantly, that a strict 6 month limit, after which the proposal would lose the protection of the moratorium, was not viable in the case of larger companies, or indeed in smaller complex situations. We are nonetheless convinced that time is of the essence in putting a proposal to creditors and we have provided every encouragement in our proposals for the provisional supervisor to put his proposal to creditors before the expiration of 6 months.

1.30 We also believe that it is important to keep court involvement to a minimum to save costs and the time involved in waiting for a hearing. This procedure can be initiated without the involvement of the court, apart from a filing requirement and in a straightforward case, a workout could be achieved within 30 days without going to the court.

1.31 The key to provisional supervision is the provisional supervisor, who would be appointed to formulate a proposal to be put to the creditors. The procedure would flow through him and his powers and functions are clearly set out in the following chapters. The main point to note is that the provisional supervisor will take control of the company as soon as he is appointed and that the management of the company and such directors as he

retains would be answerable to him.

1.32 Cost is a factor in any procedure, and is especially relevant when insolvency is looming. There has been criticism of both abuse of and unnecessary costs involved in the systems in some other jurisdictions. We would like to avoid unnecessary expense. We certainly want to avoid the procedure becoming a cash cow for provisional supervisors and for those who would seek to use it as a vehicle to make work for themselves. The more inexpensive that a procedure is to initiate and run, the more viable a proposition it becomes to a greater number of companies in difficulties.

1.33 One of the best ways of keeping costs down is to limit the involvement of the courts. The *quid pro quo* for this is the need to have practitioners of the highest quality to supervise a proposal. High quality professionals are not cheap but, under our procedure, they would have multiple responsibilities and we anticipate that vesting of control of a company and the formulation of a proposal in the provisional supervisor, which, combined with an extensive moratorium, should avoid the sort of problems associated with, for example, Chapter 11 proceedings in the United States.

1.34 We consider that only one procedure, in addition to the provisions under section 166, needs to be introduced, initially at least. We hope that the procedure would be sufficiently cheap and simple to be used by all sizes of business but we recognise that it might prove too expensive for many small businesses. This is regrettable but it is unavoidable if a system capable of withstanding the pressures of a major reorganisation is to be introduced.

1.35 This is the first attempt to put in place a comprehensive company rescue procedure in Hong Kong. We are fully aware that lessons will be learned from the experience as we cannot hope to put the perfect procedure in place at the first attempt. We recognise, and intend, that the system should be refined in time. In this context, we note that the Superintendent of Bankruptcy in Canada has undertaken an exhaustive and comprehensive survey of the new procedure under the Bankruptcy and Insolvency Act 1992 and we suggest that a similar monitoring exercise could usefully be carried out in Hong Kong.

1.36 Provisional supervision will not necessarily be used all that extensively and we would not calculate its success or failure in terms of how often it is used or as a percentage of windings up, but in terms of how successful it is as a process when it is used.

1.37 We are aware that Hong Kong has a large number of family run businesses, some of them very large and well known, and the point has been made that family businesses will not be prepared to allow a provisional supervisor take control of the business under any circumstances. This may prove to be a problem with such businesses but we believe that the relevant families will see the sense of trying to save their businesses. We hope that any distrust of the procedure would dissipate as it is appreciated that

provisional supervision can be used to save businesses.

Recognition of foreign procedures

1.38 The issue of co-operation in international insolvencies and restructurings needs to be considered in the overall context of insolvency law. For that reason, we do not make any proposals on recognition here but we will address the subject in our final report on insolvency law. We recognise, however, that co-operation between jurisdictions, particularly in the context of a restructuring of a company with interests in several jurisdictions, is desirable and we are in favour of provisions which encourage co-operation.

1.39 In this context, we note that section 426 of the Insolvency Act 1986 obliges courts in the United Kingdom as a matter of insolvency law, to co-operate with each other and that this co-operation is extended to other relevant countries, including Hong Kong. Hong Kong does not reciprocate. Section 306 of the United States Bankruptcy Code also permits co-operation with foreign courts by allowing a case ancillary to a foreign proceeding to be filed in the United States courts by a foreign representative. The new Australian Corporations Law[20] also makes provision for reciprocity with other jurisdictions.

1.40 We consider that it may be appropriate for Hong Kong to take the initiative, as the countries mentioned above have, and introduce a reciprocal arrangement. It may be limited, as under the Australian provisions, to provisional supervision or to an arrangement under section 166. In order to protect Hong Kong businesses and companies, it may be useful to take the approach of the United States Bankruptcy Code which provides that in determining whether to grant relief, the court shall be guided by what will best assure an economical and expeditious administration of the estate, consistent with just treatment of all holders of claims against or interests in such estate, protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in the foreign proceeding, prevention of preferential or fraudulent dispositions property of such estate, distribution of proceeds of such estate substantially in accordance with the order prescribed in the Bankruptcy Code and comity.

1.41 The alternative to a co-operation provision would be participation in a treaty, but this is not likely to be an option for some time to come. It has been noted that:

> *"There is a highly noticeable unwillingness or lack of attention among governments toward implementing effective multinational treaties in the insolvency area and a comparable unwillingness or lack of attention toward enacting provisions in domestic*

[20] Pan 5.7A, effective from 23 June 1993.

legislation to deal with the cross-border impact of insolvencies and reorganisations."[21]

Environment

1.42 There is a growing awareness that insolvency practitioners need to consider their potential liability for damage to the environment caused by companies with which they become involved both in terms of damage caused before and after their appointment. This is a matter of particular concern to practitioners who take over the control and management of a company, such as receivers and, in the context of our proposals, provisional supervisors.

1.43 The Hong Kong Society of Accountants prepared, in 1991, a list of environmental laws in Hong Kong as they related to creditors and creditors' representatives as part of an INSOL International project.[22] The paper listed about twenty eight Ordinances and Regulations that made provision for noise, air and water pollution, waste disposal, spills at sea, transportation of dangerous goods, hazardous goods management, waste management and occupational health and safety. The paper commented on the statutory liabilities which may affect representatives during the conduct of their roles in the following terms :-

> *"Statutory liability is imposed on persons committing an act or omission, owners and occupiers of premises. Therefore, representatives are covered if they are the ones who committed the prohibited acts, failed to comply with orders or are legal owners or occupiers of the offending premises.*
>
> *The environmental statutes impose criminal liability on offenders. Normally a fine is levied on the first conviction and a more severe fine on the second conviction. A further fine may also be imposed for every day or hour during winch the offence continues. Such liability is often imposed where the legislation provides that certain acts are prohibited or certain orders must be complied with. The liability is not retrospective.*
>
> *Regulatory liability is imposed on the grant of licences and permits. Where a breach of licensing conditions is involved, the licence or permit may be forfeited.*
>
> *Civil liability may also arise from breach of contract and tort. It is not provided for in the statutes."*
>
> *"Liability is normally strict in that once the act or omission is committed, an offence is constituted and there is no need to*

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21 E. Bruce Leonard, Co-chair, International Bar Association Committee on Insolvency and Creditors' Rights of the Section on Business Law ("Committee J") in his paper "The Committee J Initiatives in Cross Border Insolvencies and Reorganisations", Vienna, April 18, 1994.

22 Hong Kong Society of Accountants reference C/IIG, M4687, 13th August 1991.

prove that the act or omission was accompanied by any intention, knowledge or negligence. Certain statutes, such as the Water Pollution Control Ordinance and Waste Disposal Ordinance[23] *have set this out expressly."*

1.44 The possible consequences of liability for environmental damage has been of concern in other jurisdictions that may be considered to be ahead of Hong Kong in terms of environmental awareness. The Canadian Bankruptcy and Insolvency Act 1992 provides that a trustee will not be personally liable, under federal and provincial legislation, in respect of any environmental damage that occurred before the trustee's appointment as trustee or after that appointment, except where the condition arose or the damage occurred as a result of the trustee's failure to exercise due diligence.[24] It has been noted that there is hardly an insolvency in Canada today where environmental concerns are not an issue. It was also noted that trustees have become so concerned about the spectre of personal liability in respect of bankrupt estates with potential environmental problems that it has resulted in numerous situations where trustees have refused to act with respect to potential bankruptcies.[25]

1.45 Concerns have also been raised in the United Kingdom about receiver's liability under the Environmental Protection Act 1990. Under the Act a receiver may be liable if he is held to be the owner or occupier of contaminated land, or in the course of carrying on the borrower's business he causes or knowingly causes or knowingly permits the pollution of the environment. A receiver does, however, have a defence if he can show that he took all reasonable precautions and exercised due diligence to avoid the commission of the offence.[26]

1.46 It should come as no surprise to Hong Kong receivers to find dangerous goods for which premises are unlicensed and which they were unaware of when appointed. We are also aware of instances where difficulties in complying with environmental provisions have been influential in receivers deciding to wind up companies rather than trying to save them.

1.47 We consider that it would be worthwhile at this stage to attempt to establish the extent to which provisional supervisors, and by extension receivers, should be liable for environmental damage. We consider that there are two, and possibly three elements to this. The first concerns environmental damage that occurred before the appointment of the provisional supervisor. We consider that there is no reason whatsoever for liability to be imposed on a provisional supervisor in such circumstances. Any liability should remain firmly fixed on those whose responsibility it was to avoid the damage or who caused the damage, depending on the relevant provisions. Further, that

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23 Caps 358 and 354.

24 Section 14.06(2).

25 "Canadian Bankruptcy Reform: The Move from Liquidation. to Rehabilitation" Derrick C. Tay, International Insolvency Review 1993, Volume 2, pages 59 to 60.

26 See "Receivers' Liability under the Environmental Protection Act 1990", Michael Frawley, Society of Practitioners of Insolvency, Insolvency Practitioner, The Journal of the Society of Practitioner's of Insolvency, July 1993.

provisional supervision should not be allowed to be used by responsible parties to try to extract themselves from responsibility.

1.48 The second situation concerns environmental damage that occurs after the provisional supervisor's appointment. We propose following the Canadian lead in this to the effect that the provisional supervisor should not be liable for environmental damage that arose after appointment except where the condition arose or the damage occurred as a result of the trustee's failure to exercise due diligence.

1.49 The third situation is covered by our second proposal but for certainty we propose that if environmental damage is occurring or continuing as the provisional supervisor "enters the premises" he should only be liable for failure to exercise due diligence.

1.50 We would caution practitioners who act at present as receivers and managers to acquaint themselves with the environmental legislation in Hong Kong and to consider environmental implications when appropriate.

Insolvent trading

1.51 In the context of the directors acting earlier rather than later, we propose, in Chapter 19, that directors could be made personally liable for the debts of a company which traded while insolvent. The duties of directors as regards trading while insolvent would be defined. We would hope that the introduction of an insolvent trading provision would assist in encouraging directors to consider going into provisional supervision early as the prospect of personal liability would give many directors pause for thought before they allowed a company to proceed into an insolvent trading position.

Chapter 2

Companies to whom provisional supervision will apply

2.1 There are two issues involved in deciding which companies provisional supervision should apply to. The first is that we do not expect nor do we intend that supervision should become the panacea for all ailing corporations. The experience in other jurisdictions is that provisional supervision is only viable for relatively small numbers of companies. We know that it will not replace winding up, be it creditors' voluntary winding up or compulsory winding up, or even come near to matching these in percentage terms. What we are aiming for is a procedure that will facilitate the rescue of those companies that have viable businesses which are worth saving in whole or in part. In Hong Kong, this could mean a small number of companies going into provisional supervision in any one year and we anticipate that it will take some time for a rescue culture to become part of business thinking. Nonetheless, we believe that the provisional supervision procedure would benefit businesses in Hong Kong and, consequently, benefit Hong Kong as a whole.

2.2 Second, while provisional supervision should be available to as many companies as possible, there are, however, certain industries which may be exempted from the proposals for the reasons stated later in this chapter.

Companies to whom the procedure would apply

2.3 The procedure should apply to companies formed and/or registered under Parts I and XI of the Companies Ordinance but excluding the regulated industries discussed later in this chapter.

2.4 Companies registered under Part I of the Companies Ordinance account for most companies in Hong Kong, including both private and public companies. As at 31 July, 1994 there were 440,238 locally incorporated companies on the companies register. Of these 433,978 were private companies and 6,260 were public companies, 512 were companies limited by shares and 5,748 were companies limited by guarantee. A total of 3,778 oversea companies were registered under Part XI. In April 1994 the Hong Kong Stock Exchange had 275 Part XI companies listed and 201 locally incorporated public companies.[27]

[27] Source: Registrar of Companies.

2.5 Part XI of the Companies Ordinance relates to companies incorporated outside Hong Kong, which are referred to in Part XI as "oversea companies" and which are provided for as follows under section 332:-

> *"This Part shall apply to all oversea companies, that is to say, companies incorporated outside Hong Kong which, after the commencement of this Ordinance, establish a place of business in Hong Kong, and companies incorporated outside Hong Kong which have, before the commencement of this Ordinance, established a place of business in Hong Kong and continue to have a place of business in Hong Kong at the commencement of the Ordinance."*

2.6 The inclusion of overseas companies is important as Hong Kong is a major international trading, manufacturing and financial centre and there are a considerable number of international companies operating in Hong Kong in one form or another. Oversea companies operating in Hong Kong have the choice of forming a Hong Kong subsidiary under Part I of the Companies Ordinance or registering as an oversea company under Part XI. As this choice is open to oversea companies, which would include multinationals, we consider that the procedure should be available to them whether they choose to incorporate under Part I or to register under Part XI.

2.7 We note that it would be inadvisable for a provisional supervisor to be appointed over an oversea company which had most of its assets and shareholding in another jurisdiction. In such a case, it would be appropriate to use the provisional supervision as an ancillary procedure to the procedures being taken in the company's home jurisdiction.

2.8 The appointment of a provisional supervisor of an oversea company whose main business was carried out in another jurisdiction could result in local creditors only receiving the benefit of assets that were in Hong Kong, with local creditors losing out on the prospect of benefiting from a distribution from a larger pool of assets if an administrator was subsequently appointed overseas. Another consideration would be that the moratorium imposed by the procedure could not be enforced overseas, in the absence of a reciprocal agreement.

Companies to whom the procedure would not apply

2.9 We do not intend that the procedure should apply to industries that are already regulated by statute and which have provision for the relevant authority to assume control of the business or oblige a business to act in a certain manner. The industries we have identified are:

(a) Banking

2.10 The Banking Ordinance provides the Monetary Authority with extensive powers over banks and deposit taking companies. In particular, the Monetary Authority, after consultation with the Financial Secretary, may in certain circumstances, require an institution to take any action or do any act or thing in relation to its business which is considered necessary, appoint a person to advise an institution in the proper conduct of its business, and assume control of and carry on the business of an institution.[28]

(b) Insurance

2.11 Insurance companies are registered under the Insurance Companies Ordinance which provides the Insurance Authority with the powers in certain circumstances, to direct that an insurer seek advice on the management of its affairs, business or property, or that an insurer's affairs, business or property should be managed by a person appointed by the Insurance Authority.[29] It is also worth noting that the Insurance Companies Ordinance seeks to protect the long term business of an insurance company by providing that the liquidator should, unless the court orders otherwise, carry on the long term business of the insurer with a view to its being transferred as a going concern to another insurer.[30]

(c) Securities and Futures

2.12 The Securities and Futures Commission has powers to intervene in the business of registered persons. The Commission may restrict a registered person from entering into certain transactions, soliciting business from certain persons, or from carrying on business in any manner specified. There may also be restrictions imposed on dealing with assets or to maintain assets sufficient to meet liabilities in respect of the business of the registered person. The Commissioner has powers to petition to wind up a company on the just and equitable ground if it appears to him that it is expedient in the public interest. The Commissioner may also petition for a receiving order against a registered person if the registered person has committed an act of bankruptcy.[31] The Commissioner also has powers to apply to the court for an order to regulate companies which are being or have been conducted in a manner prejudicial to the interests of its members.[32]

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28 Banking Ordinance (Cap 155), section 52.

29 Insurance Companies Ordinance (Cap 41), section 41.

30 Insurance Companies Ordinance, sections 45 and 46.

31 Securities and Futures Commission Ordinance (Cap 24), sections 38 to 41, 45 (note that proceedings were taken under this section in re *MKI* Corporation Ltd, [CWU 562 of 1994]) and 46. Section 2 defines a registered person as a person who is registered under the Securities Ordinance (Cap 333), the Commodities Trading Ordinance (Cap 250) (or both these Ordinances) as a dealer, dealing partnership, dealer's representative, investment adviser, commodity trading adviser. investment advisers' partnership, investment representative or a commodity trading adviser's representative.

32 Securities and Futures Commission Ordinance, section 37A, which was introduced in the Securities and Futures Commission (Amendment) Ordinance (Ordinance No. 73 Of 1994).

2.13 Under the Securities Ordinance[33] the court, on the application of the Commission, may make orders restraining any person from acquiring, disposing or otherwise dealing with specified securities, appointing a person to administer the property of a dealer or a registered dealing partnership, declaring a contract relating to securities to be void or voidable, and directing a person to do or refrain from doing a specified act for the purpose of securing compliance with any other orders under the section.

(d) Conclusion

2.14 The powers of the regulatory bodies differ substantially, but the powers are created to meet the needs of each industry. While we do not propose that provisional supervision should be imposed on these industries we suggest that the regulatory bodies consider whether to apply a remedial procedure through their own legislation.

There is currently a case before the court, *Securities and Futures Commission v Chesterfield and others*, [MP 3504 of 1994] in respect of this provision.

[33] Securities Ordinance (Cap 333), section 144.

Chapter 3

Purposes of provisional supervision

3.1 We consider that it would be useful to set out a general statement of the purposes of provisional supervision.

3.2 The purposes are simply guidelines and we do not intend that those persons who would initiate the procedure should be obliged to state particular purposes when initiating. A provision that would limit the procedure to certain purposes would anticipate the provisional supervisor's assessment of the company's situation and the terms of his proposal. It would have the effect of burdening the provisional supervisor with purposes that he might not consider appropriate once he made an assessment of the company's affairs.

3.3 An early statement of purposes would also restrict the functions of the provisional supervisor and compromise his independence. This could result in suspicions among creditors that provisional supervision was being used by directors for their own ends and that the provisional supervisor was "in the pocket" of the directors, impressions we want to avoid.

3.4 Nonetheless, those parties who would be able to initiate the procedure would be in a position to appreciate the company's problems and take the initial action. Initiating provisional supervision would, however, be their last act of total control of the company as the provisional supervisor when appointed would take over control.

3.5 Provisional supervision leading to a voluntary arrangement is, in its simplest terms, a vehicle which would facilitate a company in avoiding winding up, to survive in whole or in part as a going concern, or satisfy its debts in whole or in part. This statement also contemplates a more advantageous realisation of the company's assets than under a winding up or a better return for creditors and members than would result from a winding up.[34]

3.6 The general purposes could be achieved in a variety of ways through voluntary arrangements that could provide for such situations as:

(a) an extension of time for payment of debts,

(b) a composition in satisfaction of its debts,

(c) the compromise of any claims against the company,

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[34] Section 2(1) of the model Bill. All references and footnotes to sections, which are not attributed to legislation in the text above the footnote means the footnote refers to sections of the model Bill set out in the Annexure.

(d) the variation or the reordering of the rating for payment of its debts or any class of its debts,

(e) the conversion of its debts in whole or in part into shares or other securities to be issued by the company, or, in order not to limit the generality of the purposes set out in the previous paragraph,

(f) any other scheme or arrangement in relation to the affairs of the company.[35]

3.7 The provisional supervision procedure aims to give a company the best possible chance of emerging from it into supervision, and subsequently from supervision, in the best state that can be achieved in a reasonably short time and at low cost. The purposes reflect the flexibility needed to allow a company to reorganise its debts and/or to restructure so that only those parts of the company which were viable would remain.

3.8 We see no point in preserving companies that should not be saved and the procedure would ultimately give creditors the power to condemn a company which was not worth saving. Such a company could then cross directly from provisional supervision into winding up. The cost, in addition to the fees and expenses of the provisional supervisor, would be that creditors' claims would be delayed for the duration of the moratorium. In the context of the average length of time it takes to make dividend payments in a compulsory winding up, the prospect of an earlier work out of claims should prove attractive to creditors.

Provisional supervision whether solvent or insolvent

3.9 A company should be able to go into provisional supervision whether it is able to pay its debts or not. A solvent company which recognises that it is trading into difficulties should be able to avail itself of supervision. It would stand a better chance of a successful reorganisation than a company that continued trading until it was insolvent.[36] We consider that it would be good management practice to act earlier rather than later in initiating provisional supervision and that there is no good reason for excluding solvent companies from the procedure. We note that the Harmer Report made much the same observation and recommendation.[37] [38]

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35 Section 2(3).
36 Note Chapter 19 on insolvent trading.
37 The Harmer Report, paragraph 56.
38 Section 2(2).

Other jurisdictions

3.10 Purposes expressed in corresponding procedures in other jurisdictions do not differ greatly from our proposed purposes. This is no coincidence as we have borrowed heavily from other jurisdictions in all aspects of these proposals.

3.11 The new Australian procedure for the administration of a company with a view to executing a deed of company arrangement under Part 5.3A of the Corporations Law seeks to provide for the business, property and affairs of an insolvent company to be administered in a way that maximises the chances of the company, or as much as possible of its business, to continue in existence, or if that is not possible, results in a better return for the company's creditors and members than would result from an immediate winding up of the company.[39]

3.12 The Cork Report considered that the purposes of administration should be to consider the reorganisation of the company and its management with a view to restoring profitability or maintaining employment, to ascertain whether a company of doubtful solvency can be restored to solvency, to make proposals for the most profitable realisation of assets for the benefit of creditors and shareholders, or to carry on the business where this is in the public interest but it is unlikely that the business can be continued under the existing management.[40]

3.13 These purposes differ to some extent from the purposes finally adopted in the Insolvency Act, on which we have drawn. The Insolvency Act's administration procedure defines its purposes as the survival of the company, and the whole or any part of its undertaking, as a going concern, the approval of a company voluntary arrangement, the sanctioning of a compromise or arrangement, and a more advantageous realisation of the company's assets than would be effected on a winding up.

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39 Corporation Law Reform Act 1992.

40 The Cork Report, paragraph 498.

Chapter 4

Those who may initiate the procedure

4.1 We set out below those whom we consider should be able to initiate provisional supervision and propose that, in addition to the company or its directors, liquidator's and receivers should be able to initiate, or give their consent to initiate, the procedure in appropriate circumstances. Our main concern is that whoever has power to initiate should do so from a position of knowledge of the company's financial position and prospects.

4.2 It is for this reason that we propose that creditors should not be able to initiate the procedure. There are practical reasons for denying creditors the power to initiate, and these are set out below, but we are concerned that because of this, the proposal might be seen as a vote in favour of a management driven procedure. This is not the case. We determined from the outset that the procedure should not be, nor should it be seen to be, a vehicle for the preservation of management's position. This is borne out, for instance, by the proposal that the provisional supervisor should take over management control of the company on his appointment and that he should not be answerable to management.[41]

Company or directors may initiate provisional supervision

4.3 The impetus for provisional supervision should properly come from the board of directors and management of a company as it is they who control the company and who are in the best position to know its financial position and business situation and the prospects for saving the company or part of it. Only management would understand fully a company's situation, including its accounts, customers, suppliers, and other creditors and their attitude towards the company, in addition to the markets and potential of the business. We therefore propose that, where no petition has been presented to wind up the company, a majority of the directors or the members of the company, by ordinary resolution, should be able to initiate provisional supervision.[42]

Provisional liquidator may initiate provisional supervision, except in respect of a declaration under section 228A of the Companies Ordinance

4.4 We propose that, where a petition has been presented to wind

41 Section 12(2).
42 Section 3(1).

up a company but before a winding up order is made, a provisional liquidator should also be able to initiate the procedure.[43] This proposal would not, however, operate in respect of a declaration by directors that a company cannot by reason of its liabilities continue in business and that it is necessary that the company be wound up under section 228A of the Companies Ordinance. If the directors reach this decision, they have decided that the company is not worth saving and it would seem to be an anomaly to provide for provisional supervision in such circumstances.

Creditors and receivers

4.5 We consider that there should be no provision for the procedure to be initiated by creditors. We base this on the belief that for the most part creditors would not have sufficient knowledge of the financial position of a company to make a judgment whether it was a candidate for provisional supervision.

4.6 There are two cases where, however, creditors would have a say in whether the procedure could be initiated. The first would be where a company's management, wanting to initiate provisional supervision, approached major secured creditors who had the right to elect whether to participate in provisional supervision.[44] We consider that this would have to happen, in any case, where a company had creditors with the right to elect, as to attempt to initiate provisional supervision without establishing that such creditors were prepared to be subject to a moratorium would be ridiculous. Although, in such a situation, creditors could not initiate, they would have the ability to indicate their position to management who would then react accordingly. Another possibility is that creditors with the right to elect would have the ability, based on knowledge of the company's financial position, to indicate to management that management should initiate provisional supervision as an alternative to the appointment of a receiver.

4.7 The second case would be where a receiver had been appointed over the whole or substantially the whole of a company's assets. We make this proposal on the basis that a receiver may consider that the best option for a company would be provisional supervision rather than a realisation of assets.[45]

4.8 We realise that by the time a receiver has been appointed a secured creditor will probably have reached a conclusion on its security, and, by extension, on the company's management, but we consider that it is better to have the option to convert to provisional supervision to allow for the occasional instance where a receiver considers that provisional supervision is viable. This is not inconceivable as institutional lenders are known to prefer to rescue debtor companies rather than let them go under. The reasons behind this have been discussed earlier.

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43 See the Companies 0rdinance, section 193 and section 3(1) of the model Bill.

44 Section 10.

45 Section 3(2)(b).

4.9 We would emphasise that we do not wish to interfere unduly with the right to appoint a receiver. Receivership and provisional supervision would be distinct processes. Presumably, creditors who had the right to appoint a receiver would consider, possibly in conjunction with a company's management, which would be the best option, receivership or provisional supervision. We propose, nonetheless, that a receiver should have the option to consent to the procedure if he considers that it is the best way to proceed.

Liquidators

4.10 After a liquidator of a company has been appointed, the company or the directors should only be able to propose that the company should go into provisional supervision with the consent of the liquidator. In our view, the time for proposals for a voluntary arrangement would have normally have passed by the time a liquidator was appointed and he should not necessarily be concerned with anything other than the realisation of the assets of the company for distribution among the creditors. There may, however, be situations where a liquidator accepts that provisional supervision would be a better solution than liquidation and we are content to leave the matter in his hands.[46]

Other arrangements under the Companies Ordinance

4.11 We consider that a proposal for a voluntary arrangement under provisional supervision may be made as an alternative to or in addition to a compromise or arrangement under section 166 of the Companies Ordinance or to a compromise, arrangement, reconstruction or any other scheme or arrangement provided for by any other section of the Ordinance. Section 166 should still have a function under the Companies Ordinance and we hope that it may be used more often once the concept of voluntary arrangements becomes more accepted.[47]

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46 Section 3(2)(a).

47 Section 3(3).

Chapter 5

The moratorium (or Stay)

5.1 The Companies Ordinance, section 166, already provides that a company can enter into a compromise or arrangement with its creditors. The major drawback of the provision is that there is nothing to prevent a single creditor during the negotiations presenting a petition to wind up the company, thereby putting a spoke in the wheel of any compromise or arrangement. The crucial difference between the existing provisions and provisional supervision is the concept of the stay of proceedings, or moratorium, which would protect the company from actions against it by its creditors during the period of the moratorium.

5.2 The moratorium is the cornerstone of provisional supervision. The scope of the moratorium, both in terms of its effect on the rights of creditors and its duration presented considerable problems in balancing the interests of the parties while trying to give the provisional supervisor adequate breathing space to formulate a proposal.

5.3 The imposition of a moratorium on proceedings against a company in provisional supervision has the dual effect of suspending the rights of the creditors during the moratorium, while preserving the assets of a company. This allows a company to continue trading and gives the provisional supervisor time to investigate the company's affairs and formulate a proposal for creditors.

5.4 We have settled on a moratorium provision, which, though not complicated, necessarily takes account of the variety of situations that can arise. For a long time during our considerations we tried to limit the length of time of the moratorium to a maximum of 6 months but we finally concluded that in provisional supervisions involving large companies or complex cases 6 months would not be enough time for a provisional supervisor to gather together all the strands of his investigation. This has been demonstrated internationally recently in cases such as Olympia and York, which achieved a work out, and in the C.H. Tung and Wah Kwong shipping groups referred to above. Even then we toyed with the idea of insisting that provisional supervision should end after 6 months as it would act as an incentive to all parties involved that time was running out after which the company would be left with the option of a compromise or arrangement under section 166 of the Companies Ordinance or it could be put into liquidation.

5.5 We concluded, reluctantly, that to terminate provisional supervision after 6 months would create such uncertainty that many companies would not even consider entering it and that, where a company did enter provisional supervision, it would be ridiculous to sacrifice 6 months' work

on the altar of a quick solution. We have therefore expanded our proposals to allow the moratorium to continue after 6 months but only with the approval of the creditors.

Court involvement

5.6 Although we have tried to keep court involvement to the minimum we consider that the provisional supervisor should make application to the court for extensions to the moratorium on a regular basis. This is because creditors' rights are suspended during provisional supervision and they must be assured that the provisional supervisor is diligently formulating a proposal to be put to them. A requirement that the provisional supervisor must justify extensions to the court would have the effect of keeping the provisional supervisor aware of his obligations and would force him to reassess the prospects of a voluntary arrangement on a regular basis.

Length of the stay in other jurisdictions

5.7 We looked at the position in other jurisdictions. There is no fixed time scale set down in the administration provisions in the United Kingdom[48] though it seems that a period of five to six months is not unusual. Similarly, there is no time scale laid down under the loosely framed Companies' Creditors Arrangement Act in Canada. A moratorium under Chapter 11 of the United States Bankruptcy Code should last for at least 4 months but can continue for years.

5.8 The Australian Corporate Law Reform Act 1992 provides for a meeting of creditors to decide whether to execute a deed of company arrangement, to end the administration, or that the company be wound up. The meeting must be convened within four to five weeks of the commencement of the administration but there is provision for the convening period to be extended by the court. The meeting of creditors may be adjourned for a further sixty days after the meeting of creditors is held.

5.9 Under the Canadian Bankruptcy and Insolvency Act 1992, however, provision is made for an initial moratorium of 30 days which can be extended for up to six months in 45 day segments on the order of the court.

5.10 We have already stated that the procedure should not be long drawn out. We have acknowledged that different companies have different problems and that while 30 days might be sufficient time for a proposal to be made to creditors in a straightforward provisional supervision, it would not be long enough in a complex case.

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48 Insolvency Act 1986, Part II.

5.11 We have therefore opted for a provision broadly following the model under the Canadian Bankruptcy and Insolvency Act 1992 as we find that the concept of a flexible stay provision which can be extended in blocks up to a maximum time provides flexibility combined with deadlines which require an explanation as to why they should be extended. We have followed the initial 30 day period provided for by the Canadian provisions but prefer the extensions to be in blocks of 30 days up to the same maximum of 6 months from the date of appointment of the provisional supervisor. In addition, we have provided for the moratorium to be extended beyond 6 months provided creditors are in agreement.

The proposed moratorium

(a) Moratorium for up to 6 months

5.12 The moratorium should commence at the same time as provisional supervision, that is, upon the filing of a resolution of the company or the board of directors and the consent of the provisional supervisor to act.[49]

5.13 The initial moratorium period should be for 30 days from the commencement of provisional supervision after which, if the provisional supervisor has not formulated a proposal for creditors, he may apply to the court for an extension or, if necessary, extensions.[50]

5.14 The provisional supervisor need only apply to the court for an extension if he finds that he is unable to complete an arrangement plan within the initial 30 day period. After that, the court should grant extensions in 30 day periods if the provisional supervisor reports that he is likely to be able to complete the plan within the next 30 days but the court should have a discretion to extend the moratorium up to a maximum of 6 months from the commencement of the moratorium if it is apparent from the circumstances of the case that the provisional supervisor is going to need more than 30 days to complete his proposal. In the case of such an extension, the court should require regular reports of the provisional supervisor. To clarify the length of the moratorium, the initial moratorium period and any court extensions when added together should not exceed a maximum period of 6 months from the commencement of provisional supervision.[51]

(b) Provisional supervisor to satisfy the court

5.15 We do not intend, however, that the court should become a rubber stamp for processing extensions to the moratorium. We propose that the court should only grant a first extension to the moratorium period if it is satisfied that the provisional supervisor is acting with due diligence in

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49 Section 7.

50 Section 9(3).

51 Sections 9(4) and (5).

formulating an arrangement plan and otherwise carrying out his functions. The provisional supervisor must also be able to assure the court that he will be likely to complete the plan within the period of the extension applied for.[52]

5.16 In any application for an extension by the court the provisional supervisor should file an application with the court before the expiration of the current extension of the moratorium but the moratorium should continue until the application is heard by the court.[53]

5.17 If the provisional supervisor finds that he requires subsequent court extensions he must again satisfy the court that he is acting with due diligence, that he is likely to complete the arrangement plan and will be in a position to call a meeting of creditors to consider the plan within the period of the extension, and that the creditors as a whole would not be materially prejudiced by the extension. A creditor opposing the extension would have the burden of proving prejudice to himself.

(c) Effect of the moratorium

5.18 We have identified several types of actions or proceedings that would be subject to the moratorium. These prohibitions would only apply to creditors who are subject to provisional supervision and are that:-

(a) no application for the winding up of the company by the court may be commenced or continued;

(b) save for such resolution of a meeting or meetings of creditors under this procedure, no resolution may be passed for the winding up of the company;

(c) no receiver of the assets of the company may be appointed or if already appointed no receiver may exercise any powers incidental to the office;

(d) no steps may be taken to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession;

(e) no proceedings, execution, attachment or other legal process may be commenced or continued against the company or its property, no distress may be levied (or if already levied no sale thereunder shall be effected) and no right of forfeiture or of entry or re-entry may be exercised;

(f) no agreement or arrangement with the company may be terminated or varied by reason only that the company is in

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52 Section 19.

53 Section 19(7).

provisional supervision.[54]

5.19 In relation to paragraph (e), we note that it would be possible for moratorium to straddle the end of the statutory limitation period for taking a particular action or proceeding against a company in provisional supervision. This would be plainly unfair to, for example, a creditor whose limitation period for taking action in respect of a debt expired during the moratorium. We intend to provide therefore that, during the moratorium, the running of time in respect of statutory limitation periods would be suspended.

5.20 Paragraph (f) is to prevent the establishment of a practice of providing the other party to a contract with a device to get out of a contract with the company in the event of provisional supervision. This would have the effect of, for example, preventing suppliers to the company in provisional supervision from pulling out of their agreements. The *quid pro quo* for this is that new supplies would have to be paid for from company assets in priority to payment for supplies made and other debts of the company incurred, before provisional supervision.

5.21 We intend that paragraph (e) above would extend to leases and hire purchase contracts. This would include the Government in respect of proceedings for arrears of, for example, rent but would not apply to resumption by the Government in respect of a Crown lease.

(d) Eligible financial contracts exempted

5.22 In addition to creditors who might be exempted, we consider that there are certain types of dealing that should be exempted from the moratorium. These are known as eligible financial contracts which occur in certain closed markets. The problem with attempting to impose a moratorium on such contracts is that it could involve unravelling innumerable other contracts which would cause chaos in the market affected. An example of such a market in Hong Kong is The Stock Exchange of Hong Kong Limited which employs a central clearing and settlement system. We accept that in such a case the provisional supervisor would have to wait for the contracts to be settled in the relevant market and accept the net termination value which is the net amount obtained, either a gain or a loss, after setting off the mutual obligations between the parties involved, at the end of the period.[55]

5.23 We have borrowed from the Canadian Bankruptcy and Insolvency Act 1992 in identifying eligible financial contracts but would be grateful for submissions on any type of relevant contract that might have been missed. The eligible financial contracts identified are:-

(a) a currency or interest rate swap agreement,

(b) a basis swap agreement,

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[54] Section 9(9).

[55] Section 9(12).

(c) a spot, futures, forward or other foreign exchange agreement,

(d) a cap, collar or floor transaction,

(e) a commodity swap,

(f) a forward rate agreement,

(g) a repurchase or reverse repurchase agreement,

(h) a spot, futures, forward or other commodity contract,

(i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities,

(j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i),

(k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j),

(l) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (k), or

(m) any agreement of a kind prescribed;

5.24 If an eligible financial contract entered into before commencement of provisional supervision is terminated after the commencement of the provisional supervision and the company in provisional supervision is found to be in debt to the other party after settlement, the other party should be considered to be a creditor of the company for the amount due for the purposes of the provisional supervision or any subsequent winding up.

Where the creditors' meeting resolves to extend the moratorium

5.25 After the end of 6 months the court ceases to have any role in monitoring the provisional supervisor as regards extensions of the moratorium. If the creditors resolve to extend the moratorium beyond 6 months they may impose such conditions as they wish on the provisional supervisor relating to reviewing the extension. In any event, the provisional supervisor should call a meeting of creditors to consider the matter before the end of 6 months if he proposes that the moratorium should continue beyond 6 months.

5.26 A meeting called to vote on renewing the extension, and any subsequent meetings, would resolve either to continue the moratorium or to terminate it, in which case the company would be wound up and a liquidator appointed.

5.27 If at any time during such extensions the provisional supervisor decides that he is unable to formulate an arrangement plan within the extension period he should call a meeting of creditors to consider a further extension.[56]

Creditors affected by a court moratorium

5.28 A creditor affected by the moratorium may oppose an application to the court for an extension of the moratorium. If the court is satisfied that the moratorium is causing significant financial hardship to the creditor the court may exempt that creditor from the moratorium and any voluntary arrangement and the moratorium shall cease to apply to that creditor and he shall not be subject to any subsequent voluntary arrangement. The effect is that the provisional supervisor would have to reach an accommodation with that creditor outside the provisional supervision. This might involve satisfying the creditor's claim in part or in full. We see no easy solution to such a situation but we cannot justify a company finding sanctuary in provisional supervision that would result in significant hardship to another person or business and may even put that business in jeopardy.[57]

Creditors excluded from the moratorium

5.29 We propose elsewhere that the provisional supervisor should have the power to exclude any class or classes of creditors from the moratorium, in which case the moratorium would cease to apply to them. Again, we anticipate that in such circumstances the provisional supervisor should have reached an accommodation with the class involved as otherwise any one of the creditors of that class could petition for the winding up of the company.

Crown bound

5.30 The Crown should be treated no differently from other creditors and should be bound as creditor by a moratorium.[58]

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56 56 Section 19(9).
57 57 Section 19(8).
58 58 Section 33.

Employees

5.31 A problem arose recently in the United Kingdom where it was held that a form of letter, often referred to as a *"Specialised Mouldings letter"*, used by administrators and administrative receivers did not have the intended effect of avoiding the adoption of contracts of employment.[59] The Court of Appeal held that where an administrator of a company continued more than 14 days after his appointment to employ staff and pay them in accordance with their previous contracts, he was impliedly adopting the contracts of employment. All contractual liabilities arising after the 14 days were payable as an expense of the administration in priority to the administrator's own remuneration and expenses.[60]

5.32 The decision resulted in amendments being made to the Insolvency Act[61] to limit the extent to which liabilities in relation to employees rank as expenses of the receivership or administration to such wages or salary or contributions to occupational pension schemes as are incurred after the relevant office holder had adopted the contract of employment.

5.33 We consider that the provisional supervisor should be similarly protected and that provisions in line with the recent amendments under the Insolvency Act 1986 would be appropriate.

End of the moratorium

5.34 The moratorium should cease upon a resolution being passed either to terminate the provisional supervision[62] or that the company should be wound up or on the approval or rejection by creditors of a voluntary arrangement plan.

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59 *Powdrill v Watson* [1994] 2 All ER 513 CA (commonly known as the *Paramount Airlines* case).

60 The House of Lords upheld the Court of Appeal, saying that where the conduct of an administrator or administrative receiver of a company amounted to an election to treat a continued contract of employment with the company as giving rise to a separate liability in the administration or receivership, the contract was "adopted" within the meaning of sections 19 and 44 of the Insolvency Act 1986 and the administrator or receiver could not avoid the consequence by telling the employee that he was not adopting the contract or was only doing so on terms. The Times, 23 March 1995.

61 Insolvency (No.2) Act 1994, which amended section 19 of the Insolvency Act in respect of administrators and section 44 in respect of administrative receivers.

62 See sections 17(12)(a), 19(14)(b) and 20(7)(c).

Chapter 6

Initiating the procedure

6.1 We have stated above that provisional supervision should be initiated by a resolution of the directors or the members of a company. Certain procedural matters must be carried out in order to put provisional supervision into effect. These procedures have considerable significance to provisional supervision as they trigger the commencement of the moratorium. In addition, as the court would not be involved in the procedure, apart from dealing with such matters as extensions to the moratorium, it is necessary to set out the procedures that should be followed. We propose that, in order to make the resolution effective, the following procedures should apply.

Documents to be filed and their effects

6.2 A proposal for a voluntary arrangement should not have any effect until the following documents have been filed at both the Supreme Court Registry and the Companies Registry:-

(a) a copy of the prescribed resolution of the company or the board of directors proposing a voluntary arrangement, or, if appropriate, of the proposal in the form prescribed of the liquidator in a compulsory winding up; and

(b) the consent to act of the provisional supervisor.[63]

6.3 The effect of the filing of the documents would be to put the company into provisional supervision, the commencement date being the date of last filing of the resolution and the consent to act.[64] Documents filed in the Official Receiver's Office are date and time stamped. Documents filed in the Supreme Court Registry are date stamped with the time of filing noted on the document by the person filing the document. The moratorium would have effect from the date of commencement and would apply in respect of the company and its creditors.[65]

6.4 We consider that it is necessary to file a copy of the resolution in court, in addition to the Companies Registry, as if the company is subsequently wound up it would be necessary to fix a date from which winding up should have effect.[66] This is particularly significant in relation to such matters as fraudulent preferences under section 266 of the Companies

63 Section 6(2).
64 Section 7.
65 Section 9.
66 Section 6(3).

Ordinance, which sets a time limit in respect of fraudulent preferences of 6 months before the commencement of winding up. In addition, the court would be involved in the provisional supervision to some extent and filing would initiate the court's involvement.

Appointment of the provisional supervisor

6.5 The commencement of the provisional supervision would correspond with the appointment of the provisional supervisor and from that date the powers and duties of the provisional supervisor would take effect .[67]

Gazetting and advertising

6.6 In any case which stands a chance of putting a successful voluntary arrangement in place, the provisional supervisor should be able to easily establish the names of creditors and the amounts of their debts from the records of the company. Nevertheless, as we propose that all creditors should be bound by any voluntary arrangement agreed by a meeting of creditors, it is necessary to be seen to have attempted to reach any creditors who may not have been identified from the records.

6.7 Provisional supervision should also be an open process and the fact of provisional supervision should be made known to creditors immediately. As soon as possible after his appointment, the provisional supervisor should advertise notice of the proposal for a voluntary arrangement, in a form prescribed, in the Hong Kong Government Gazette and in English and Chinese language newspapers.[68]

6.8 In addition, as soon as possible after his appointment, and possibly at the same time as the advertisement giving notice of the provisional supervision, the provisional supervisor should give notice to creditors asking them to give notice in writing of their claims within 7 days. At least seven days before the meeting of creditors, the provisional supervisor should also advertise in the same way, a notice requiring creditors who have not yet submitted their claims to do so within two days before the meeting or meetings of creditors.[69]

Meetings of creditors

6.9 The provisional supervisor should call a meeting or meetings of creditors once he has formulated an arrangement plan, when he finds that he is unable to complete a plan within 6 months of the commencement of the

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67 Section 7(b).
68 Section 8.
69 Sections 17(7), 19(11) and 22(4).

moratorium or when he decides that none of the purposes of provisional supervision can be achieved.[70]

[70] See Chapter 15 for the situations on which the provisional supervisor can call a meeting of creditors. See also sections 17(5), 19(9) and 20(1).

Chapter 7

Who may be the provisional supervisor

7.1 The question of who should fulfil the role of provisional supervisor is of great significance as the provisional supervisor must be seen by creditors to be independent of the management of the company and to be a skilled operator in the area of insolvency and company rescue. This is especially relevant in the context of our proposals that, for the most part, provisional supervision would be initiated by the directors or members of a company and that, once appointed, he would not be supervised by the court, except in relation to extensions of the moratorium. The role therefore is one that requires expertise and integrity.

7.2 In the context of these criteria, we consider that only solicitors and accountants should be able to act as provisional supervisor's.[71] This is a qualified proposal as, ideally, we would like to see specialist insolvency practitioners act in the role. The problem is that there is no recognised body of licensed insolvency practitioners in Hong Kong though we are aware that there is a movement towards the establishment of such a body.

7.3 There are, however, a number of accountants and solicitors who are skilled in insolvency and company rescue matters. We propose that, when and if such a body is established, its members alone should be allowed to act as provisional supervisors. We would add a word of caution. Both professions embody a diversity of skills and are becoming increasingly specialised. When selecting a provisional supervisor those involved in initiating the procedure should take care to choose an accountant or solicitor skilled in company rescue and insolvency matters. Neither creditors nor the court would be impressed to find that the provisional supervisor was an accountant whose main practice was in taxation or a solicitor whose expertise was in criminal litigation.

7.4 Once the provisional supervisor is appointed he would not only assume control of the company but would also need to be involved in the day to day business of the company in addition to formulating an arrangement plan. In many cases, this would require skilled back up from the provisional supervisor's associates and staff. In effect, in all but the smallest of cases, the role of the provisional supervisor in all likelihood could not be carried out by one person.

[71] Section 5.

Independent person

7.5 Once a provisional supervisor is appointed he should not be capable of being removed, either by a resolution of a meeting of creditors, or by those who appointed him or by the court. It is important that the provisional supervisor should have this security to prevent interested parties from gaining leverage over him by threatening to have him replaced and from taking up the provisional supervisor's time fighting off challenges to his appointment. We considered a proposal to the effect that the provisional supervisor should be a person who has had no previous substantial connection with the company, whether as a professional adviser to the company, or as a partner or employee of a firm which had a significant connection with the company, or as a creditor or shareholder of the company.

7.6 We have decided, however, to make no such stipulation as it would be difficult to define a substantial connection and, it could result in challenges to the provisional supervisor that could distract him from, and thus hinder, the preparation of a proposal. In addition, accountants and solicitors function under the rules of their respective professional bodies. We consider that it would be appropriate for the provisional supervisor to function under the rules of his or her particular profession.[72] We also note that in a recent survey it was reported that when an investigating accountant is later asked to take a receivership, the business is far more likely to be rescued than if a totally fresh insolvency practitioner is brought in as receiver.[73]

Provisional liquidator as provisional supervisor

7.7 Where provisional supervision is proposed by a provisional liquidator of a company, he should be able to nominate himself to be the provisional supervisor if he fulfils the qualifying criteria. Whether a liquidator meets the qualifying criteria or not he may nominate any other qualified person to be the provisional supervisor.[74]

Joint appointment as provisional supervisor

7.8 We favour the idea of an individual appointment of a provisional supervisor as it personalises the position and complements the concept of independence. We have discussed the possibility of allowing the appointment of joint provisional supervisors. There is a parallel for this in the Companies Ordinance, where section 235(1) provides that the company in general meeting may appoint one or more liquidators for the purposes of winding up a company. In practice what tends to happen is that joint liquidators, when appointed, are from the same firm and one of them will take on the day to day work of the liquidation. The beauty of this is that if one of the liquidators

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72 Section 5(1).

73 Insolvency Practitioner, the Journal of the Society of Practitioners of Insolvency, January 1995, page 27.

74 Section 5(2).

becomes indisposed, for any reason, the other liquidator can carry on without the need to call a meeting of creditors to appoint a new liquidator.

7.9 It has been suggested that the question of whether to appoint one or more provisional supervisors should be left to those who initiate the procedure and we have no objection to this in principle. It was also suggested that it might be possible to appoint an individual provisional supervisor but that those who initiate, or the provisional supervisor, may nominate an alternate in the event of the provisional supervisor becoming indisposed. We feel that this would be an awkward provision and do not endorse it. For the purposes of this paper, however, we will stick with our proposal that the appointment of provisional supervisor should be an individual appointment but we welcome submissions on the issue.

Chapter 8

Role of the provisional supervisor

Level of involvement

8.1 The provisional supervisor would operate within tight time constraints and, in formulating a proposal, would have a considerable amount of work to do. It is necessary therefore to determine the responsibilities of the provisional supervisor not only in terms of formulating a plan for a voluntary arrangement but also in terms of his level of control over the company and his involvement in the day to day running of the company.

8.2 As regards the level of involvement in the day to day running of the company, we realise that there may be problems no matter which option we choose. If the provisional supervisor is to content himself with examining the records of the company and working behind the scenes to formulate a plan, while leaving the day to day running of the company in the hands of the management, there is a danger on two fronts.

8.3 First, the provisional supervisor might fail to gain the confidence of the creditors if it is perceived that he is not in full control. This problem seems to have arisen in the role of an examiner under the Irish examinership provisions where the examiner does not take on executive functions. This is left to the existing management of the company. It has been suggested that an effect of the debtor remaining in possession in a jurisdiction which, like Hong Kong, has no tradition of debtor in possession, is that creditors are uneasy with the position:

> *"While the split functions between management and examiner are theoretically pure, they ignore the reality of how creditors have become accustomed to dealing with insolvencies. It is simply not possible for the examiner to remain in his ivory tower, musing over possible viability plans while, downstairs, creditors are demanding their goods back or are refusing to supply further goods, no matter what legal priority is being offered."*[75]

8.4 Second, if a provisional supervisor does not have control over the management of a company it increases the chances of the company's assets being dissipated by unscrupulous directors. There is a danger that, unless there are adequate safeguards, the directors of a company might use provisional supervision as a vehicle for dissipating assets and avoiding statutory liabilities.

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[75] Article in the Irish Times by Eugene McCague, Solicitor, 25th June 1993.

8.5 We consider that it would not be appropriate to allow management to retain full control of a company and accordingly the provisional supervisor should have executive functions. The creditors are, after all, being asked to show considerable forbearance during the moratorium. It is important that they should be reassured that the management of a company is not using the moratorium as an opportunity to dissipate the company's assets while the provisional supervisor is occupied in formulating a proposal. In the context of taking over the executive functions of the company, the provisional supervisor would take over the statutory duties of the directors, such as filing annual returns.

8.6 The involvement of the provisional supervisor in the management of a company brings its own problems, not least in terms of costs. The taking over of full responsibility for the management of a company, while at the same time formulating a plan, could involve the provisional supervisor flooding the company with his own people and reducing the level of involvement of the existing management to a minor role or no role. This is a situation we wish to avoid as we consider it important that the management of a company should remain in place in so far as that is possible. A responsible management team that is fighting to preserve the company, and thus their jobs, is of far greater use to the company than a management team that has been dismissed.

Functions of the provisional supervisor

8.7 We have identified the functions of the provisional supervisor in the course of a provisional supervision as follows:

(a) to assess the financial position of the company, after which he should;

(b) decide whether or not any of the of the purposes of a voluntary arrangement are capable of being achieved;

(c) if he decides that any of the purposes of a voluntary arrangement are capable of being achieved, he should then formulate a plan to achieve the intended purpose;

(d) once he has formulated a plan, he should submit it to a meeting or meetings of creditors for acceptance or otherwise by the creditors within the initial moratorium period in so far as that is possible;

(e) if the provisional supervisor, having assessed the financial position of the company, decides that none of the purposes of a voluntary arrangement are capable of being achieved he should call a meeting of creditors;

(f) if the provisional supervisor, having commenced the formulation of an arrangement plan, finds that he is unable to complete the formulation of the plan, he should call a meeting of all creditors to provide them with a final opportunity to come up with a plan to save the company or to resolve that the company should be wound up;

(g) during the provisional supervision period he shall do all things necessary to protect the assets of the company;

(h) during the provisional supervision he shall manage the affairs, business and property of the company with the primary purpose of preserving the assets of the company for the creditors as a whole;

(i) he should act in the best interests of the company. [76]

Provisional supervisor as agent of the company

8.8 The provisional supervisor should be deemed to be the agent of the company in the exercise of his powers.[77]

The relationship between the provisional supervisor and the directors[78]

8.9 It is necessary to clarify the relationship between the provisional supervisor and the directors of the company. We have several concerns as regards this relationship, as the prospects for a successful resolution of a company's problems are enhanced if the relationship between the provisional supervisor and the directors is well understood and is one of co-operation. This will not happen in some cases but we wish to emphasise the value we place in securing the co-operation of the directors in a situation that is never going to be comfortable for them.

8.10 Our proposals contemplate that the existing directors would have recognised that the company was in difficulties and sought the appointment of a provisional supervisor. In so doing, the directors would have recognised that they needed help in rescuing the company from its difficulties and, we hope, such recognition should make for a greater level of co-operation between the provisional supervisor and the directors than would exist if provisional supervisor had been imposed on the directors.

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76 Section 11.
77 Section 12(6).
78 See generally sections 12 and 13.

(a) The position in other jurisdictions

8.11 The level of involvement of directors in the management of companies under provisions in other jurisdictions varies. Chapter 11 in the United States has attracted criticism for following the principle of debtor in possession, an approach that is followed, again subject to criticism, in Examinership in the Republic of Ireland. Under the administration procedure in the Insolvency Act 1986, once an administration order is made the administrator takes control of all of a company's property and of its management and has the power to appoint or dismiss directors.[79]

8.12 In Canada, the proposal provisions under the Bankruptcy and Insolvency Act 1992 provide that, unless the proposal specifies to the contrary, the debtor retains the entire administration of his property. In Australia, while a company is under administration, the administrator has control of the company's business, property and affairs and may carry on the business of the company and manage its property and affairs. The powers of the directors are suspended during administration but there is some scope for a limited involvement by senior officers of the company.[80]

8.13 We have not followed any of the provisions we examined on the role of directors but we have borrowed from some of them. We have steered away from the concept of the debtor in possession by vesting control and management in the provisional supervisor but we also see benefits in the directors managing the company.

(b) Advantages and disadvantages of involving the directors

8.14 Directors know the business, they may have considerable interest in saving it, they may be able to bring new money in to the company, they may be encouraged to take action before it is too late, and they would undoubtedly save on the costs of provisional supervision if they remained in place.

8.15 The directors may lack skill and experience. They may be unable to take a fresh view of what needs to be done, they may not be able to borrow new money from the banks, they may be resistant to a change of control, and they may be motivated by a desire to cover up previous improprieties.

8.16 Directors, however, are likely to have a considerable vested interest in a company. This may come in the form of salary, shareholdings and/or loans to the company. Directors would often, therefore, have as much or more to lose as anyone else if their company was to go out of business.

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79 Insolvency Act 1986, section 14.

80 Corporate Law Reform Act 1992, sections 437A and 437C.

8.17 Directors should be involved in the running of a company but as we propose that their powers should vest in the provisional supervisor, it is in his discretion whether to delegate, and, if so, which powers to delegate back. We propose that during the provisional supervision period the powers and duties of the directors should be suspended. The powers and duties would vest in the provisional supervisor who would act in the name of the directors.[81]

Directors' actions during provisional supervision

8.18 It should be impressed on directors to whom powers are delegated that their duties are to act in the best interests of the company and that during the provisional supervision period they should not allow or permit:-

(a) any disposition of any fixed asset of the company;

(b) any payment by the company, other than a payment made in the ordinary course of business and on usual commercial terms;

(c) any charge or security, real or personal, by the company;

(d) any disposition, dealing or payment to a director or to any member of a director's family or to any company or person associated directly or indirectly with a director.

(e) any act, payment or thing to be done not in the ordinary course of business of the company.

8.19 If any director allows or permits the company to do any act or thing in contravention of these prohibitions he should be guilty of an offence and be liable to fines and imprisonment.[82]

Directors' actions prior to provisional supervision

8.20 Directors' actions prior to provisional supervision would be open to scrutiny by the provisional supervisor who would, in the course of provisional supervision, need to make a judgment on their capabilities. This judgement could result in the dismissal of some directors even in a well run company. The decision to initiate provisional supervision is not intended to be a soft option and directors could not avoid the fact that their jobs would be on the line. Nevertheless, we consider that the some or all of the existing directors are likely to have a role in the provisional supervision as they will be vital to the continuation of the company's business during that time and this should extend on into the period of the voluntary arrangement.

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81 Section 12(3).

82 Section 13(3).

8.21 We recognise, however, that each case would be different. We therefore propose that the provisional supervisor should take into his custody or under his control all the property to which the company is or appears to be entitled and that he should do all such things as may be necessary for the supervision and management of the affairs, business and property of the company.[83]

Delegation of his powers by the provisional supervisor

8.22 Subject, however, to his overriding duty to supervise the provisional supervision and his stated functions, we consider that it would be a proper exercise of his powers for the provisional supervisor to delegate such powers as he considers appropriate powers back to the existing management. Any delegation of powers and duties should be made on such terms and conditions as the provisional supervisor might lay down and should be in writing. The provisional supervisor should also be able to revoke any powers and duties delegated as he sees fit.[84]

Power to remove and appoint directors

8.23 The provisional supervisor should have the power to remove directors whom he considers are not necessary to the future running of the company. It stands to reason that the provisional supervisor should be able to remove directors whom he considers are not up to their jobs or who are obstructing him in the preparation of a proposal. We do not believe that the provisional supervisor should be obliged to give reasons for removing a director.

8.24 The provisional supervisor should also have the power to appoint new directors to the company whether to fill a vacancy or otherwise without being obliged to provide any explanation.[85]

Other powers of the provisional supervisor

8.25 In addition to the powers that we have outlined above the provisional supervisor would require the following additional powers if he is to be able to carry out his functions:[86]

(a) to appoint a solicitor or accountant or other professionally qualified person to assist him in the performance of his functions and to dismiss any such appointee;

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83 Section 12(1) and (2).
84 Section 12(3)(i).
85 Section 12(4).
86 Section 12(3).

(b) to appoint an agent or employ any person to do any business which he is unable or which may not conveniently be done himself and to dismiss any such appointee;

(c) to do all acts and execute any deed, receipt or other document in the name of the company;

(d) to make any payments necessary or incidental to the performance of his functions;

(e) to use the company seal and chop;

(f) to draw, accept, make and endorse any bill of exchange or promissory note in the name of or on behalf of the company;

(g) to raise or borrow money and grant security therefor over the property of the company;

(h) to make any arrangement or compromise on behalf of the company;

(i) to call any meeting of the members or creditors of the company;

(j) to disclaim onerous contracts;

(k) to do all other things incidental to his functions.

8.26 In relation to (h), we are aware that creditors who make an arrangement with the provisional supervisor could gain at the expense of creditors who remain subject to provisional supervision in the event that the company is subsequently wound up but the reverse is also true, especially if provisional supervision results in a voluntary arrangement with the remaining creditors. We see no problem with providing for arrangements as the provisional supervisor would be obliged to look to the interests of all the creditors before making an arrangement and he would not enter into an arrangement unless he considered that it was in the interests of the remaining creditors to do so.

8.27 Disclaimer of onerous property, in the case of a company that has been wound up, is provided for under section 268 of the Companies Ordinance and we intend that this provision would be adapted to provisional supervision. We intend to consider disclaimer in our final report on insolvency. This would relate to disclaimer both in the context of winding up and provisional supervision. We note, for instance, that there are new disclaimer provisions under section 268 of the Insolvency Act 1986, which tend to broaden the concept of disclaimer, but that these provisions do not apply to administration or company voluntary arrangements. We are also of the view

that disclaimer is a difficult area to legislate for and we need to consider the issue in overall insolvency terms.[87]

Provisional supervisor may apply to the court for directions

8.28 The provisional supervisor should be able to apply to the court for directions in relation to any particular matter arising in connection with the performance of his functions and duties or the exercise of his duties.[88]

Persons dealing with the provisional supervisor

8.29 Any person who deals with the provisional supervisor in good faith and for value should not be concerned to inquire whether the provisional supervisor is acting within his powers. We consider that this provision is reasonable to safeguard parties dealing with the provisional supervisor or the company in the course of provisional supervision. This is made more relevant by the requirement that all receipts and documents of the company would state that it is in provisional supervision.[89]

87 Section 12(3)(xi).
88 Section 12(5).
89 Section 12(7).

Chapter 9

Ascertaining the company's affairs

Information and assistance

9.1 When the provisional supervisor is appointed he will need to assimilate a great deal of information in a short time, including establishing the extent and whereabouts of the assets of the company and taking control of them. As soon as possible after he is appointed, the provisional supervisor should be obliged to investigate the business, property, affairs and financial circumstances of the company.[90]

9.2 In order to achieve this, the provisional supervisor would need powers to require information to be put at his disposal without undue delay and for assistance to be afforded to him by those who have knowledge of the company's affairs. The provisional supervisor should therefore have the power to obtain a statement of affairs of the company within a relatively short time after his appointment. With the time constraints imposed on the provisional supervisor by the procedure, he would not have time to indulge in a long drawn out battle with the parties who should be able to provide a statement of affairs and, accordingly, the provisional supervisor should have the power to oblige all or any of the persons specified below to provide a statement of affairs. [91]

Specified persons

9.3 The persons who should be obliged to provide the provisional supervisor with a statement of affairs are:

(a) any past or present officer of the company,

(b) any person who has taken part in the formation, promotion, administration or management of the company in the year before the appointment of the provisional supervisor,

(c) any employee or person employed by the company in the year before the appointment of the provisional supervisor whom the provisional supervisor believes is capable of providing relevant information or assistance, and

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90 Section 14.

91 Section 15.

(d) any employee or officer of a company which was within the year before the appointment of the provisional supervisor an officer of the company in provisional supervision.[92]

9.4 If a specified party, without reasonable excuse, fails or refuses to provide the requested information or assistance he should be guilty of an offence punishable by a fine and or imprisonment.[93]

Statement of affairs

9.5 The provisional supervisor should be able to require all or any of the specified persons to provide him with a statement of affairs of the company within 7 days of the supervisor requesting them to do so. The statement of affairs should contain:

(a) particulars of the company's assets, debts and liabilities,

(b) the names and addresses of creditors of the company,

(c) details of any securities held by creditors and the dates when the securities were given, and

(d) such further or other information as the provisional supervisor may reasonably require.[94]

9.6 In addition, the provisional supervisor should be able to require a specified person to deliver to the provisional supervisor, immediately on being requested, all documents and records relating to the company in his possession or control and to inform the provisional supervisor of the whereabouts of any documents or records of which he is aware and to provide the provisional supervisor with any other information relating to the business, property, affairs or financial circumstances of the company that is within his knowledge.[95]

9.7 The provisional supervisor should also be able to require a specified person to attend on him when reasonably requested to do so.[96]

9.8 We do not consider these obligations to be onerous on the parties specified as they do not require the specified parties to reveal or do more than is within their knowledge or control. We accept that the time limits imposed might cause some difficulties for specified parties, who could be banks and firms of accountants and solicitors who were involved in say, the formation of the company, but we believe that this is more than balanced by the benefits that may accrue to the company.

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92 Section 15(5).
93 Section 15(6).
94 Section 15(2).
95 Section 15(3).
96 Section 15(4).

Costs of providing a statement of affairs

9.9 It is usual in companies winding up for the estate to bear the costs of engaging an accountant to assist the directors in the preparation of the statement of affairs. We propose that a specified person's reasonable costs and expenses of preparing a statement of affairs of a company may be paid out of the company's assets, provided the costs are first sanctioned by the provisional supervisor.[97] Such cost and expenses should rank after the payment of the provisional supervisor's fees and expenses.

9.10 There was a suggestion that directors who were subsequently found liable for insolvent trading should be obliged to pay the costs of preparation of the statement. We consider that this should be left to the discretion of the court.

[97] Section 15(7).

Chapter 10

Duties, rights and liabilities of the provisional supervisor

10.1 Subject to his overriding duty to supervise the affairs of the company and to carrying out his functions, the provisional supervisor should be under a duty to do all things necessary to protect the assets of a company for the benefit of the creditors.[98]

Application by the provisional supervisor to the court for directions

10.2 The provisional supervisor should have the right to approach the court for directions.[99] We have already noted this elsewhere in this paper.[100] This proposal bears out the need for registering the resolution of the board of directors proposing provisional supervision in court as filing would enable the provisional supervisor to go to the court for directions.

Liability of the provisional supervisor

(a) Debts which arose before provisional supervision

10.3 The provisional supervisor should not be liable for any of the debts of the company which arose before his appointment. Such debts would be the subject of the proposal for a voluntary arrangement to be put to the existing creditors.[101]

(b) Adoption of contracts by the provisional supervisor and existing contracts

10.4 The provisional supervisor should not be deemed to have adopted any contract entered into by the company prior to the commencement of the provisional supervision. No contract entered into by the company prior to the commencement of provisional supervision, however,

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98 Section 12(2).
99 Section 12(5).
100 See paragraph 8.28.
101 Sections 24 and 25.

should be determined or deemed to be determined by reason only that the company is in provisional supervision.[102]

10.5 There are two points to note. First, on a practical level, a provisional supervisor would need to be careful about accepting deliveries of goods in respect of, for instance, supply contracts. He might have to make it clear that acceptance of a delivery did not constitute an adoption of the contract but only an acceptance of delivery on an order by order basis. Second, it may be argued that if a provisional supervisor did not have to adopt contracts entered into by the company, there should be no need for him to have the power to disclaim onerous contracts.[103] We consider, however, that a provisional supervisor should have both options available as it would take some time for him to come to grips with all the obligations of the company. If he subsequently finds that a contract of, for instance, a supply of goods was onerous he should have the power to disclaim it notwithstanding that he has accepted some deliveries.

Fresh debt incurred by the company during provisional supervision

10.6 A problem arises, however, in relation to new obligations taken on by the provisional supervisor after his appointment and before a voluntary arrangement, if any, is agreed. A proposal for a voluntary arrangement would need to contain provisions for the payment of fresh debt in priority to existing debt otherwise it is unlikely that a company could keep trading. Those who do business with the provisional supervisor after his appointment would want assurances that they will be paid for their goods or services in full as they would be apprehensive about receiving payment when the existing creditors are subject to a moratorium on their debts. There is no simple solution to this problem. If the company is to survive it must continue trading.[104]

10.7 This problem was identified by the Harmer Report[105] which noted that, in some cases, priority rights of payment in schemes of arrangement had proved worthless. The Harmer Report recommended that an administrator should be liable for debts incurred by the administrator in the course of the administration for services rendered, goods purchased or property hired, leased, used, or occupied. Debts incurred without the administrator's knowledge or approval would not give rise to liability. The Harmer Report also recommended that the personal liability of the administrator should extend to liability for rent or similar obligations in respect of possession, use or occupation of property during the administration but that this liability should not apply for the first 7 days of the administration.[106] The Corporate Law Reform Act 1992 adopted these recommendations in great

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102 Section 25(3) and (4).
103 See paragraph 8.27.
104 See Chapter 12 on super priority.
105 The Harmer Report, paragraphs 88 to 93.
106 The Harmer Report, paragraphs 89 and 90.

part.[107]

10.8 We propose that the provisional supervisor should only be personally liable on any contract entered into by him in the performance of his functions, except in certain circumstances, but that he should be entitled to an indemnity out of the assets of the company.[108]

Indemnity

10.9 The provisional supervisor should be indemnified out of the property of the company for all debts for which he is liable as provisional supervisor and for his remuneration and all reasonable expenses of the provisional supervision. The indemnity should have priority to all other claims, whether secured or unsecured, against the company. The indemnity should also be secured by way of lien over the property of the company and it should have priority over all other securities over the property of the company.[109]

Remuneration

10.10 The provisional supervisor should be entitled to such remuneration as is agreed between him and whoever initiated the procedure and caused him to act. The amount of the remuneration should be specified in the prescribed form of consent to act. The level of remuneration should be open knowledge and the provisional supervisor's consent to act form should have the amount of remuneration displayed prominently. We do not expect that the provisional supervisor should specify a lump sum amount as it would be impossible to predict how long provisional supervision would last. We do consider, however, that a provisional supervisor should be able to estimate a reasonable remuneration on a month to month basis. This would tie in with the extensions of the moratorium by the court. We do not wish to see provisional supervision becoming a jamboree for practitioners to the detriment of creditors and everyone else and hope that this small measure will help establish a reasonable market rate for the job.[110]

Payments for property used by the company

10.11 We considered, but finally rejected a proposal that, in circumstances where the provisional supervisor took control of a company which had leases or other agreements existing under which the company continued to use or occupy, or to be in possession of, property of which another person was the owner or lessor, the provisional supervisor could become liable for so much of the rent or user fee and, where appropriate, rates, management fees and service charges payable by the company under

107 Sections 443A and 443B.
108 Section 24(1).
109 Section 24(1) and 28.
110 Section 27.

the agreement as was attributable to a period:

(i) which began more than 7 days after the commencement of the provisional supervision period; and

(ii) throughout which:

(a) the company continued to use or occupy, or to was in possession of, the property; and

(b) the provisional supervision continued.

10.12 We rejected the proposal on the basis that such a provision would apply in most provisional supervisions and would act as a deterrent to provisional supervisors to take on the function.

10.13 In addition, it would have been proposed that the provisional supervisor would have been taken to have adopted such an agreement, or to be liable under the agreement otherwise than as indicated above. The provisional supervisor would have been entitled to be indemnified out of the assets of the company in respect of any liability that arose in this context. The liability of the company would not have been affected by these provisions nor would the appointment of a provisional supervisor have constituted a breach of covenant of any such agreement.

Chapter 11

Removal or resignation of the provisional supervisor

Removal of and reporting on the provisional supervisor

11.1 We do not intend to make any provision for the removal of the provisional supervisor as we are concerned to preserve his independence from his nominators and from the various interested parties he will deal with in the course of the provisional supervision.

11.2 There are, however, certain safeguards built in to the procedure. The provisional supervisor would be obliged to go to the court on a regular basis to seek extensions to the moratorium, if required or to report on progress.[111] Before granting an extension the court must be satisfied that the provisional supervisor is acting with due diligence in his functions. In addition, the provisional supervisor, in seeking an extension, would be obliged to state whether be believed that he would be likely to complete the arrangement plan within the period of the extension. In effect, before each application for an extension, the provisional supervisor must examine the progress of the proposal and the state of the company.

11.3 If the provisional supervisor does not carry out his functions, duties and powers in good faith and with due diligence it should become clear to the court, which could decline to grant an extension.

11.4 In addition, where a provisional supervision does not result in a voluntary arrangement and the company is wound up, if it appears to the liquidator that the provisional supervisor was in breach of his obligations, the liquidator should make a report to this effect. Where the liquidator is not the Official Receiver, he should forward his report to the Official Receiver. The Official Receiver should then have power to apply to the court for an order that the provisional supervisor be disqualified from acting as such for such period as the court thinks fit and may forward the report to the provisional supervisor's professional body.

11.5 It is possible that the provisional supervisor would become liquidator of the company and subsequently liquidator but this would be unlikely if creditors were unhappy with his performance as provisional supervisor.

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[111] See paragraph 5.14.

Resignation of the provisional supervisor

11.6 The role of provisional supervisor would require a high level of commitment and perseverance. We are anxious to avoid a situation that would permit a provisional supervisor to resign where a provisional supervision continued for longer than anticipated or if the formulation of a plan became protracted and difficult. We do not want to see the situation occurring of the provisional supervisor walking away from the company either during, or at the end of, provisional supervision. He should be obliged to continue as supervisor or liquidator, as the case may be, unless someone else is prepared to take over. It should be clearly understood by the provisional supervisor when he takes on the role that he must see it through to a conclusion, be it a resolution to terminate the procedure, a resolution to wind up the company or the acceptance of a voluntary arrangement. He should not be able to vacate his office until one of these conclusions is reached unless there are substantial grounds for so doing. We propose that the ethical rules and practices of solicitors and accountants should be extended to cover them undertaking provisional supervision and company voluntary arrangement work.

11.7 This approach may be seen as being hard on provisional supervisor's but we consider that practitioners do not have to accept an appointment and that, if they accept an appointment, they would be fully aware of their responsibilities. The provisional supervisor's qualifications need to be impressive and we want to foster an understanding in the business community that the provisional supervisor is there to stay, even to the bitter end. A responsible practitioner should take time before appointment to consider the position before accepting the appointment. All of this goes to the viability of a voluntary arrangement in the first place. The potential provisional supervisor's first thought should be whether a voluntary arrangement can be achieved, not whether he can milk the company for a few months and then abandon it when funds begin to dry up.

11.8 There are sure to be circumstances where the provisional supervisor would, for exceptional reasons, be unable to continue in office. Our guidelines for the resignation of the provisional supervisor are, however, strict. A provisional supervisor should only be allowed to resign by obtaining the leave of the court.[112] The court should only grant leave when it is satisfied that the circumstances are exceptional, where for the provisional supervisor to continue in office would cause severe personal hardship to him, and a replacement has been nominated and consented to act. Before applying to the court for leave to resign, the provisional supervisor should give notice of his intended application to whoever nominated him and the nominator should nominate a replacement. In the case of a liquidator acting as provisional supervisor, the notice would be given to the court.[113]

11.9 Where a provisional supervisor dies, becomes mentally incapable, or ceases to be a person who may be a provisional supervisor, the

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112 Section 29(1).

113 See section 29 generally.

nominator or, if appropriate, the court, should nominate a replacement.[114]

11.10 The appointment of the replacement provisional supervisor should take effect upon the filing of his consent to act in the Registry of the Supreme Court and the Companies Registry. The appointment should be advertised and gazetted.[115]

11.11 On the appointment of a replacement provisional supervisor the previous provisional supervisor should be released from office and from all future liability in respect of the provisional supervision.[116]

11.12 It should be an offence for a provisional supervisor to continue in office when he has ceased to be a person qualified to act as provisional supervisor.[117]

Where a company goes from provisional supervision into liquidation

11.13 If a company goes into liquidation before a voluntary arrangement has been approved, the provisional supervisor, if he is not the liquidator, should pass over all documents and disclose all information obtained by him in the provisional supervision to the liquidator.[118]

114 Section 29(5)
115 Sections 29(6) and (7).
116 Section 29(11).
117 Section 29(9).
118 Section 29(12).

Chapter 12

Super priority[119]

12.1 We consider that provision should be made for a company to borrow during provisional supervision and that such borrowing should receive priority over existing debts, that is, a super priority over all existing debts. We make this proposal because, in all likelihood, a company in provisional supervision would need to raise capital to fund its operations during the provisional supervision period. This raises concerns for the other parties involved as it would, firstly, be necessary to assure super priority lenders that their capital would have priority over existing lending and, secondly, to satisfy existing creditors, suspicious of additional liability in priority to their debts, that the priority debt was a necessary part of the process.

12.2 In great part to satisfy these concerns, we believe that any super priority borrowing should come from the existing lenders to the company. This should have the effect of reassuring other creditors that they are not dealing with opportunist lending as the super priority lender will be seen to be committing additional debt to its existing exposure. Super priority lending would probably come from the company's bankers, who would have security in respect of their existing lending, and who would therefore have had the right of election to stay outside provisional supervision. Super priority lending by a secured creditor which had the right of election would be seen to be an act of faith by the principal lenders in the procedure.

12.3 Super priority lending to the company by any creditor subject to the moratorium provisions should have priority to the debts of all creditors, be they preferential, secured, unsecured, or otherwise, subject to the moratorium. Super priority lending would also have effect for the purposes of any voluntary arrangement and for the purposes of any subsequent winding up of the company.

12.4 Super priority lending would apply only to funds provided for working capital for the company and these funds should not be used to discharge, in whole or in part, any liability of the company to the provider of the funds existing at the commencement of the provisional supervision period. The use made of such funds should include, but should not be limited to, advances of monies and the provision of credit by suppliers of goods and services or the suspension of liability to pay by the suppliers of goods and services or lessors of property used by the company.

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[119] Section 26.

12.5 We recognise that further lending to a company that is already in financial difficulties is not a comfortable prospect for lending banks as, if the original security was not adequate, their capital adequacy position might be affected. This could mean that a lender could be required by the Monetary Authority to top up its capital adequacy ratio. In such a situation, a lender might decide that it would be prudent to look to its own position and proceed to realise its security rather than have it locked up in a moratorium.

Chapter 13

Secured creditors

13.1 Under current commercial and legislative conditions, secured creditors have the right, on the happening of certain events, to appoint a receiver and manager over the whole of a company's undertaking under the terms of the debenture. We consider that to impose a moratorium on secured creditors would ignore the point that the prospects for a voluntary arrangement would probably rely heavily on support from a company's principal secured creditors both in the form of backing for the procedure and for further borrowing during provisional supervision. As a consequence, we consider that certain secured creditors should not be forced into the procedure but should be given the option to elect to remain outside the procedure.[120] The probable consequence of such and election would be to end any prospect of a voluntary arrangement.

13.2 The treatment of secured creditors of a company that proposes going into provisional supervision is central to the prospects of a voluntary arrangement being achieved. There is no avoiding the rights of secured creditors and their importance in the world of business and we do not intend to radically alter those rights as to do so would, we believe, result in the major source of secured lending, the banks, opposing these proposals. The whole procedure, essentially, is a balancing of the interests of all those concerned. A successful marriage of the interests of the parties concerned should ultimately work to the benefit of all.

13.3 The position and power of holders of a floating charge in general business life is one that has exercised the courts for over a hundred years and which was analysed in the Cork and Harmer Reports. It is not the remit of this paper to dwell on the merits or otherwise of the concept of the floating charge. Our purpose is to try to fit the supervision procedure in with established legal concepts, of which the concept of the floating charge is one. The floating charge is so widely used in the common law world that it would be foolish for Hong Kong to interfere in isolation with one of the primary tools of commerce. Indeed, the Cork Report noted that:

> *"So widespread has the use of the floating charge become, that today it is thought that the greater part of the loan finance obtained by the corporate sector, particularly in the case of the finance obtained from the banking community, is raised upon the security of such charges, and that the greater part of the materials in the course of processing and of the ordinary stock in trade of the corporate sector is subject to them."*[121]

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120 Section 10 and see paragraph 4.6.

121 The Cork Report, paragraph 104.

13.4 It is necessary, however, to set out what is meant by a floating charge and what it achieves. The Harmer Report defined it in the following terms:

> *"Despite the recent emergence of many varied techniques of corporate business financing, the floating charge is possibly the most used, particularly by institutions such as banks, which remain the major source of corporate finance for private and non-listed public companies. A floating charge is a unique security. It typically has the following features.*
>
> - *It comprehends all the property of a company. Despite the common use of the description 'floating' charge, it normally contains both a fixed and a floating security. The property of the company which it holds other than for direct trading purposes, such as office or factory premises and plant and equipment, is made subject to a specific or fixed security. The company's trading stock, debtors and other property which is 'employed' in day to day business is made subject to a floating security.*
>
> - *It covers present and future assets.*
>
> - *Some of the assets covered by the floating charge are likely to change from time to time in the ordinary course of business of the company.*
>
> - *Until one of a number of possible specified events has occurred (such as default by the company causing the chargeholder to take some steps to realise its security or the company ceasing its business), the company has virtually complete freedom to deal with the assets covered by the floating charge in the ordinary course of its business and to give good title to those assets. However, when one of those events has taken place the charge crystallises and becomes a fixed security over all the assets of the company (both present and future) covered by the charge. The chargeholder can either appoint a receiver of the property and income of the company or take possession of it for the purpose of realising the charged assets and recovering the debt owed to it".*[122]

[122] The Harmer Report, paragraph 179.

Right to election for major secured creditors

13.5 In consequence, we consider that a major secured creditor, that is, the holder of a floating charge over the whole or substantially the whole of a company's assets, whose level of exposure would warrant such an extensive charge, should not have provisional supervision imposed on it by a company seeking provisional supervision. Such major secured creditors should have the right to elect not to participate in the provisional supervision.

13.6 Under our procedure, provisional supervision would have commenced before a major secured creditor was asked to elect, though in practice, we anticipate that a company would have consulted with major secured creditors before going into provisional supervision and would know that the major secured creditors would elect to participate. Should a major secured creditor elect not to participate, however, provisional supervision would immediately cease.[123] If major secured creditors elect to participate, or make no election within 3 days of receipt of the notice of election, provisional supervision should continue and the major secured creditors would be subject to provisional supervision.[124] Providing a company with the option of going into provisional supervision without having to obtain the prior consent of major secured creditors would give a company some leverage, in that the act of going into provisional supervision might, in itself, persuade major secured creditors to participate.

13.7 The effect of an election not to participate and thus end provisional supervision would return a company to the position it was in just a few days previously. Creditors, secured and unsecured, would take the usual forms of action, though a provisional supervision of such short duration would set alarm bells ringing for creditors and the consequences for a company could be bleak. It does no harm therefore to emphasise that provisional supervision should be prearranged by a company with its major secured creditors, and that other creditors are presented with *a fait accompli.*

13.8 A minority of members of the sub-committee considered that a company should obtain the prior consent of its major secured creditors before it went into provisional supervision. Obtaining prior consent would ensure that the major secured creditors were behind a company when it went into provisional supervision. The minority also considered that, if the prior consent of major secured creditors was a requirement, the unnecessary expense involved in a company going into provisional supervision and then out again shortly afterwards would be avoided.

Other secured creditors

13.9 Other secured creditors, that is, (i) fixed charge holders and (ii) holders of floating charges whose level of exposure does not warrant a

123 Section 10(3).
124 Section 10(4).

charge over the whole or substantially the whole of a company's assets, would be bound by a moratorium in the same way as unsecured creditors, and would not have the option to elect whether to participate in the moratorium. We consider that it is not feasible to allow other secured creditors the option to elect. Firstly, there could be a considerable number of them, particularly in the case of a major company seeking provisional supervision. Secondly, it has frequently been commented on by practitioners that creditors secured for smaller amounts tend to obstruct reorganisation plans in the hope of being bought out by the other creditors. We want to avoid this kind of negative action. Under our proposals, a buy out of a creditor could only happen on the initiative of the provisional supervisor the effect of which would be to exclude the creditor from a proposal for a voluntary arrangement.

(i) Fixed charge holders

13.10 The holder of a fixed charge over property would probably be reluctant to release its right to the security unless it was going to do better under provisional supervision. Given the right to elect, a well secured fixed charge holder would probably elect to remain outside provisional supervision. We consider that holders of fixed charges should be subject to the moratorium and should not have the right of election. Fixed charge holders would not be jeopardised to the same extent of holders of floating charges, who would be more likely to see their security decline in the course of provisional supervision.

(ii) Lightweight charges

13.11 There is a possibility that some secured creditors, in order to achieve the right of election, would attempt to create what are known as "lightweight charges". This form of charge has emerged in the United Kingdom as what has been described as "an Insolvency Act expedient", to protect charge holders whose level of exposure does not necessarily warrant it, by creating a floating charge that allows the charge holder veto the making of an administration order.[125] These charges are so called because they need not contain all the covenants and restrictions typically found in floating charges, but only restrictions on the creation of other floating charges ranking ahead of or *pari passu* with them. Under the Insolvency Act, the charge holder could also appoint an administrative receiver.[126]

13.12 The position in the United Kingdom is complicated by the provisions under the Insolvency Act. There are, however, implications for Hong Kong as the right of election would be an attractive option for a secured creditor as it would allow the secured creditor to block provisional supervision. The advantage of this is plain. The provisional supervisor would have a duty to carry out proposals aimed at achieving the purposes of provisional supervision. The affect of his appointment and the moratorium is to remove

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125 For a full discussion, see "Lightweight Floating Charges" by Dr Fidelis Oditah [1991] JBL 49.

126 Insolvency Act 1986, section 28(2).

two vital rights from the chargee, the ability to control the timing and conduct of realisation of his security.

13.13 For our purposes, we simply wish to put down a marker that lightweight floating charges should not be allowed to develop in Hong Kong. The right of election should be the province of a lender whose security over the whole or substantially the whole of the undertaking of the company is a true reflection of the level of lending. Secured creditors would, in any event, be protected in that the provisional supervisor could not dispose of secured property without the consent of the secured creditor.

Provisional supervision should complement existing procedures

13.14 As previously stated, we see provisional supervision as complementing the established winding up provisions and the existing rights of secured creditors and other parties rather than frustrating them. It is not possible, however, to successfully operate provisional supervision without a moratorium to protect a company while a proposal is being worked out and the rights of many creditors and other parties against the company would be suspended during that period. The potential benefit to all parties to a voluntary arrangement under supervision is obvious. In the event that provisional supervision failed to result in a voluntary arrangement and is terminated, the parties involved would be able to avail of the remedies which were stayed during the moratorium, probably with no greater loss than the loss of the time of the stay.

Chapter 14

Procedure the provisional supervisor follows in the formulation of a proposal to present to creditors

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Provisional supervisor to decide whether a voluntary arrangement can be achieved

14.1 The provisional supervisor would be under considerable time pressure during the provisional supervision period. It would be necessary, as soon as practical after the provisional supervisor has ascertained the financial position, to decide whether the purposes of a voluntary arrangement are capable of being achieved. He should do this within the initial 30 day moratorium period, as in order to apply for an extension of the moratorium he has to advise the court that he will be likely to complete the arrangement plan within the period of the extension. If he has not formed the view that a voluntary arrangement can be achieved he would be unable to make this representation.[127]

Consultation by the provisional supervisor

14.2 In determining the terms of the plan, the provisional supervisor should have the power to consult with the directors and officers of the company as well as with the company's accountants, creditors, members, and any other party the provisional supervisor believes could be of assistance.[128]

If a voluntary arrangement can be achieved

14.3 If the provisional supervisor decides that any of the purposes of a voluntary arrangement are capable of being achieved he would proceed to prepare a draft voluntary arrangement plan for consideration by creditors, within the 30 days if possible. Apart from a requirement that the plan should be in the nature of a draft voluntary arrangement, the contents of the plan should be entirely at the discretion of the provisional supervisor.

14.4 In preparing an arrangement plan, the provisional supervisor might find that he wished to exclude a creditor or creditors and it should be in his discretion to do so provided that alternative arrangements had been

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127 Section 9.

128 Section 18(3).

agreed. Once agreement has been reached, the provisional supervisor should file a notice of exclusion in both the Supreme Court Registry and the Companies Registry. The effect of this is that provisional supervision would cease to apply to excluded creditors, though they would be bound by the terms of their agreements with the provisional supervisor.

14.5 When the provisional supervisor formulates a plan he should call a meeting of creditors to consider it. If, having commenced the formulation of a plan, the provisional supervisor finds that he cannot complete it, he should report to the creditors that he is unable to formulate a plan.

If a voluntary arrangement cannot be achieved

14.6 If the provisional supervisor decides that none of the purposes of a voluntary arrangement can be achieved he shall call a meeting of creditors to inform them.[129] The meeting should be held without delay and the notice of meeting should state that it is being held to consider the decision of the provisional supervisor that none of the purposes of a voluntary arrangement are capable of being achieved.

14.7 The meeting should resolve to terminate provisional supervision and to wind up the company and appoint a liquidator.

14.8 When he calls the meeting the provisional supervisor should give creditors the relevant background information which caused him to decide that a voluntary arrangement could not be achieved. He should prepare a report detailing the business, affairs, property and finances of the company, a projected cash flow statement of the company, and a statement of the reasons why the provisional supervisor considers that a voluntary arrangement cannot be achieved. These documents should be available for inspection at the provisional supervisor's office.

14.9 For any resolution to pass at such a meeting there should be a majority in number and in excess of one half in value of the creditors present in person or by proxy and voting on the resolution.

14.10 If the creditors resolve that provisional supervision should terminate and the company should be wound up, the company should be deemed to have been in a creditors' voluntary winding up from the date of the appointment of the provisional supervisor. This provision would be necessary to prevent provisional supervision being used as an avoidance tool by directors seeking to go out of time in relation to such things as, for example, the 6 months limit for fraudulent preferences under section 266 of the Companies Ordinance.

14.11 If the meeting of creditors resolves that the company should be wound up as a creditors' voluntary winding up the provisional supervisor

[129] Section 17(5) and see generally section 17(6) to (12).

should be deemed to have been appointed as liquidator of the company, in the absence of another person being appointed, to facilitate the winding up process. This provision is necessary for the continuation of the process. It would be unsatisfactory if the provisional supervisor could walk away from a company in the absence of another person being appointed as liquidator. We would not like to see a situation where this could happen as it would only serve to devalue the procedure which must be carried through to a conclusion.[130]

14.12 If a provisional supervision is terminated because the creditors have resolved that the company should be wound up, the provisional supervisor should file notices of cessation of the provisional supervision in both the Supreme Court Registry and the Companies Registry.

No quorum

14.13 If there is no quorum at the meeting it should be deemed that the company should be wound up.[131]

130 See paragraphs 11.6 and 11.7.
131 Section 17(13) and see paragraph 16.23.

Chapter 15

Requirements for meetings of creditors

15.1 This chapter is procedural and sets out the three situations in which the provisional supervisor would need to call a meeting of creditors. The resolutions that can be made at these meetings are defined as we consider that the provisional supervisor and creditors should understand the purpose of the meeting and that there are a limited number of conclusions that can be reached. This should prevent meetings from becoming side-tracked because if a meeting cannot reach one of the positive resolutions, then the resolution common to all types of meeting, that is to terminate provisional supervision and to wind up the company, must be made. This approach is consistent with our principle that if a voluntary arrangement is agreed it is more likely to succeed if there is no delay. In limiting the resolutions, we are cutting down the opportunity for procrastination, not least among creditors who would like to be excluded from the procedure.

15.2 In considering the feasibility and formulation of an arrangement plan the provisional supervisor would have cause to call meetings of creditors in three particular circumstances. Each of these circumstances require separate provisions to facilitate the purposes of the meeting, the resolutions that can be made, and the reporting requirement on the provisional supervisor, as they vary in each case.

15.3 The different circumstances are (i) where the provisional supervisor is satisfied that he will complete the formulation of an arrangement plan, (ii) where it appears to the provisional supervisor that he will be able to complete the formulation of an arrangement plan but not within 6 months of the commencement of provisional supervision, and (iii) where the provisional supervisor decides that none of the purposes of provisional supervision can be achieved.

15.4 For all of these types of meeting there are common provisions, such as, that creditors shall form a single class and 7 days' notice in writing of the meeting should be given by the provisional supervisor. We also propose that copies of all resolutions of meetings should be certified by the provisional supervisor and filed in the court and the Companies Registry.

Where the provisional supervisor decides that none of the purposes can be achieved

15.5 In this situation, which should happen within the initial

moratorium period, the provisional supervisor should call a meeting of creditors to report his decision to them.[132] As it is possible that the provisional supervisor would not know the names and addresses of all the creditors in such a short period of time, the notice of meeting should be sent to those creditors of whose claim the provisional supervisor is aware.[133]

15.6 The notice of meeting should inform creditors of the resolutions that could be made at the meeting and that the following documents are available for inspection at the office of the provisional supervisor:

(a) a report of the provisional supervisor concerning the business, property, affairs and financial circumstances of the company and any other matters that would assist the creditors to make an informed decision,

(b) a statement of the provisional supervisor's reasons for deciding that he considers none of the purposes of a voluntary arrangement are capable of being achieved.[134]

15.7 The meeting should resolve:

(a) to terminate the provisional supervision; and

(b) that the company should be wound up and a liquidator be appointed.[135]

Where the provisional supervisor is satisfied that he will complete the formulation of an arrangement plan within 6 months

15.8 Where the provisional supervisor is satisfied that he will complete the formulation of an arrangement plan he will call a meeting of creditors to consider the completed plan.[136] A notice of the meeting should be sent to all creditors who have not been excluded from the provisional supervision and who appear in the statement of affairs, and any other creditors known to the provisional supervisor.[137]

15.9 The notice should inform creditors of the resolutions that can be made at the meeting and that the following documents are available for inspection at the office of the provisional supervisor:

(a) a report of the provisional supervisor concerning the business, property, affairs and financial circumstances of the company and

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132 Section 17(5).
133 Section 17(7).
134 Section 17(9)
135 Section 17(8).
136 Section 20(1).
137 Section 20(4).

any other matters that would assist the creditors to make an informed decision,

(b) a projected cash flow statement,

(c) a statement by the provisional supervisor of this decision that any, and specifying which, of the purposes of a voluntary arrangement can be achieved, and

(d) a draft arrangement plan.[138]

15.10 The meeting of creditors should be able to resolve to:

(a) approve the draft arrangement plan with or without modifications, or

(b) adjourn the meeting to allow the provisional supervisor to submit a modified arrangement plan, or

(c) reject the plan and resolve that the company should be wound up and a liquidator appointed.[139]

15.11 An arrangement plan should be deemed to be approved when the resolution approving the arrangement plan is passed. The provisional supervisor would have to consent to any modification to the arrangement plan.[140]

Where it appears to the provisional supervisor that he will be able to complete the formulation of an arrangement plan but not within 6 months of the commencement of provisional supervision

15.12 In this situation, the provisional supervisor should call a meeting to consider a further extension of the moratorium. The extension would be referred to as the "creditors' extension" and would not involve the court. This meeting should be called and held before the expiration of 6 months from the commencement of provisional supervision.

15.13 The notice should inform creditors of the resolutions that can be made at the meeting and that the following documents are available for inspection at the office of the provisional supervisor:

(a) a report of the provisional supervisor concerning the business, property, affairs and financial circumstances of the company and any other matters that would assist the creditors to make an

138 Section 20(6).
139 Section 20(5).
140 Section 20(9).

informed decision,

(b) a projected cash flow statement, and

(c) a statement of the provisional supervisor as to why he has been unable to complete the formulation of the plan within the moratorium period.[141]

15.14 The meeting of creditors should be able to resolve to:

(a) to extend the moratorium for such period and on such terms as the meeting may decide ; or

(b) not to extend the moratorium and that the company should be wound up and a liquidator appointed.[142]

15.15 The meeting may, however, require the provisional supervisor to call subsequent creditors' meetings to review the extensions periodically, but where the extension is for 6 months or more the provisional supervisor should call a meeting within one month of the end of 6 months from the date of the resolution to extend, or the last meeting to review the extension, as appropriate.[143]

15.16 The effect of making provision for creditors' extensions is that provisional supervision could, in theory, continue indefinitely. This is unlikely to happen as creditors only have so much patience and the requirement on the provisional supervisor to call regular meetings obliges him to give creditors the opportunity to terminate the procedure if they do not agree that it is likely to result in a voluntary arrangement.

15.17 A meeting to review an extension to review an extension should resolve to:

(a) continue the extension, or

(b) extend the extension, or

(c) terminate the extension and that the company should be wound up and a liquidator appointment.[144]

15.18 As a final safeguard, if the provisional supervisor finds that he would be able to complete the formulation of an arrangement plan, but not within the extension period agreed by the creditors, he should call a meeting of creditors to consider a further extension to the moratorium.

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141 Section 19(13).
142 Section 19(14).
143 Section 19(16).
144 Section 19(17).

Chapter 16

Procedures for meetings of creditors

Classes of creditors

16.1 The main problem we encountered in deciding the procedures to be adopted for meetings of creditors was the question of whether there should be provision for meetings of classes of creditors or for a single meeting at which all creditors would vote.

Separate classes

16.2 We decided early in our deliberations that the most democratic approach would provide for classes of creditors who would vote on the proposal for a voluntary arrangement at separate meetings. We envisaged that, in most cases, there would be at least two classes, secured and unsecured creditors, but it was probable other classes would emerge. These could include employees and other preferential creditors, secured creditors who had a right of election and those that did not, and suppliers.

16.3 We considered that the provisional supervisor would decide on the classes and that there would be no provision for aggrieved creditors to appeal to the court for review of the provisional supervisor's decision. This, in itself, might be viewed as harsh. Ultimately, however, we decided, by a majority, that separate classes could result in creditors tying the provisional supervisor up in court for long periods on interlocutory matters. The minority view is that there should be provision for classes of creditors and that the moratorium should only suspend their rights pending the outcome of a meeting of creditors of that class. The minority also considers that a meeting of both secured creditors and unsecured creditors may have the effect of subjecting the rights of the secured creditors to those of the unsecured creditors.

16.4 The majority believe that provision for separate classes of creditors would not work under our proposals as they would act against our concept of a cheap, quick and efficient system. We found time and again in discussion that classes had an impact on just about every aspect of the procedure and tend to create unwanted complexity. The majority considers that the provisional supervisor would be hamstrung by the need to present a proposal for a voluntary arrangement to different meetings of creditors, any one of which, if they voted against the proposal, would have to be excluded.

The consequence would be that the proposal would have to be modified and perhaps re-presented to the other classes. In addition, the creation of classes could suggest that the provisional supervisor intended to treat classes differently, which would lead to charges of partiality on the part of the provisional supervisor.

16.5 Once a class excluded itself by voting against a proposal it could no longer be part of provisional supervision and would not be bound by the moratorium. This would facilitate a tactical vote against the proposal by a class on the basis that, if excluded, the provisional supervisor would have to compromise with the class for more and/or sooner than was proposed in the draft voluntary arrangement in order to prevent members of the class taking proceedings against the company.

16.6 There was also the difficulty of providing against secured creditors surrendering security in order to vote tactically as unsecured creditors in anticipation of defeating the proposal in that class.

16.7 Another problem was time. For the provisional supervisor to be able to complete the formulation of a plan and have it accepted by creditors in 6 months or less, the need to put his proposal to a number of different interests, any one of which could defeat him, would have an effect on the preparation of a proposal as it would leave the provisional supervisor exposed to lobbying by the various interests.

A single class

16.8 In contrast, a single meeting of creditors, for both secured and unsecured creditors, is a clearer and simpler option. The majority of members consider that the proposals offer adequate protection for all creditors' interests in the requirement that, for a resolution to be approved on a proposal for a voluntary arrangement, there must be a vote of a majority in number and in excess of two thirds in value. This would protect the larger creditors, usually secured, as they are likely to possess the bulk of the debt and it would also protect smaller creditors, who should outnumber the secured creditors.

16.9 In Canada, however, the recently introduced voluntary arrangement provisions have a complex structure for voting by creditors as a whole or in classes as provided for in the proposal. A recent report by the Superintendent of Bankruptcy in Canada on the first year of operation of the procedure makes no mention of any difficulty with the class system. Special provision is made for secured creditors, in that, where a proposal is made to one or more secured creditors in respect of secured claims of a particular class, the proposal must be made to all secured creditors in respect of secured claims of that class. Secured creditors may be included in the same class if the interests of the creditors holding those claims are sufficiently similar to give them a commonality of interest, taking into account:

(a) the nature of the debts giving rise to the claim;

(b) the nature and priority of the security in respect of the claim;

(c) the remedies available to the creditors in the absence of the proposal, and the extent to which the creditors would recover their claims by exercising those remedies: and

(d) the treatment of the claims under the proposal, and the extent to which the claims would be paid under the proposal.

16.10 When disputes arise in relation to classes, application may be made to the court to determine the classes of secured creditors which are appropriate to a proposal and the class into which any particular secured claim may fall. At a meeting of creditors, creditors vote by class with all unsecured claims consisting of one class, unless the proposal provides otherwise, and secured creditors divided into classes according to the criteria above. The proposal is deemed accepted by the creditors if, and only if, all classes of unsecured creditors vote for the acceptance of the proposal by a majority in number a two thirds in value of the unsecured creditors of each class voting on the resolution. The votes of secured creditors do not count for purposes of determining whether the proposal has been accepted but decides whether the proposal will be binding on that class of secured creditors.[145]

16.11 The Canadian Superintendent of Bankruptcy has recorded that, in the first eight and one half months of operation, 380 proposals were initiated by corporations under the Bankruptcy and Insolvency Act, with a further 30 applications under the older, less structured, Companies' Creditors Arrangement Act. This contrasted with 100 corporate proposals filed for the same period the previous year. By mid-July 1993 some 71 % of the proposals were still surviving, indicating a good start for the procedure.[146]

16.12 Alternatively, we were interested to note that recent proposals in the United Kingdom on changes to the company voluntary arrangement and administration procedures under the Insolvency Act 1986, which makes no provision for classes, make no mention of the introduction of classes. We understand that there is no real argument for the introduction of classes but that this is probably because there is no proposal to interfere with the rights of secured creditors to realise their security or to receive the full benefit of their security.

16.13 There is an argument in the United Kingdom that class voting would give secured creditors, particularly the banks, too much power and that it would be too difficult and complex for a provisional supervisor to have to administer in formulating a proposal for a voluntary arrangement. It is worth

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145 Further criteria may be prescribed by regulations from time to time. Extracted from an article by Derrick C Tay in the International Insolvency Review, Spring 1993; Vol 2; Issue 1, entitled "Canadian Bankruptcy Reform: The move from liquidation to rehabilitation."

146 "The First Year of the Bankruptcy and Insolvency Act: The policy and regulatory perspective." George F. Redling, Superintendent of Bankruptcy, Canada. The Companies Creditors Arrangement Act 1985 was originally enacted in 1933 with principal amendments in 1953.

noting that classes of creditors are recognised under section 425 of the United Kingdom Companies Act 1985, in relation to compromises and arrangements which may be more appropriate for complex situations. There is apparently a problem with section 425 in that the court will not give directions on classes, on which the provisions are silent, identified before the meetings, but will only deal with objections when the scheme is put before it for sanction.

Chairman

16.14 The provisional supervisor, or his representative, should be the chairman of any meeting of creditors. We recognise, however, that the provisional supervisor might prefer to have someone else chair the meeting in order to free the provisional supervisor of the procedural obligations of the chairman and to allow him more time to think about matters of substance. In such a case, the provisional supervisor should be able to nominate an employee or partner experienced in insolvency matters to take his place.[147]

Notices

(i) General Notices

(a) Notice to creditors of claims

16.15 One of the first actions the provisional supervisor should take would be to advertise a notice to creditors asking them to give notice in writing of their claims within 7 days of publication of the advertisement. This relates to the tight time limits the provisional supervisor faces and to the need for him to establish as soon as possible the extent of the company's liabilities. We consider that 7 days should give sufficient time for most creditors to file a claim. We have provided generally that all types of notice should be 7 days, for the same reasons.

16.16 The option was for a period of between 5 to 10 days, with 7 days being the compromise settled on. We recognise that the time constraints make giving adequate notice to creditors difficult but conclude that, for the greater good, the provisional supervisor can only give the level of notice we propose in the limited time available. A longer period would cause unreasonable delay to the provisional supervisor. The notice of claim could be included in the advertisement placed by the provisional supervisor of the proposal for a voluntary arrangement.[148]

16.17 Nonetheless, there may be untraced creditors who come forward at a later date. This would not affect their claims, as they can be admitted at any time, or their rights to vote at the meeting. They should,

147 Section 21(3).
148 Section 16.

however, be bound by the terms of any voluntary arrangement accepted by the creditors at a meeting.

16.18 The notice should be published in one English language and one Chinese language newspaper published in Hong Kong.[149]

(b) Notice of meeting of creditors

16.19 Meetings of creditors should also be advertised in newspapers under the same conditions as above, giving creditors 7 days notice of any meeting. This would apply to a first or any adjourned meeting of creditors. The notice of meeting should require creditors who have not already done so to submit their claims in writing at least 2 days before the meeting.

(ii) Personal Notices

16.20 The provisional supervisor should give all creditors whose claims are known to him, and whose addresses are known to him, 7 days notice in writing of the meeting of creditors. The notice applies to the three occasions for meeting dealt with in the previous chapter. The provisional supervisor should take the names of creditors from the books of the company, the statement of affairs of a specified person, claims made in writing to a notice, and from any other source. It would be a mistake for the provisional supervisor to rely on the statement of affairs alone as creditors could be overlooked or deliberately excluded by the specified person.

16.21 All notices of meeting, whether general or personal, should set out the time, date and place of the meeting and specify the purposes of the meeting. Notices should also, where appropriate, advise that relevant reports and statements of the provisional supervisor are available at his office for inspection.

Quorum

16.22 The quorum for any meeting of creditors should be three creditors present and entitled to vote, or, if there are fewer than 3 creditors, all the creditors entitled to vote. This follows Rule 123 of the Companies (Winding-up) Rules. In addition, if there is no quorum within 30 minutes from the time appointed for the meeting there should be no adjournment and it should be deemed that the company should be wound up.[150]

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149 Section 16(2).

150 See paragraph 14.13.

Proxies

16.23 At any meeting, creditors should be entitled to vote either in person or by proxy. Rules 131 to 141 of the Companies (Winding-up) Rules should be adapted to apply to a provisional supervisor. In particular, we note that a form of proxy should be sent with every notice to creditors and that a creditor should be able to appoint the provisional supervisor, or the Chairman if he is not the provisional supervisor, to act as his proxy.[151]

16.24 We considered excluding the provisional supervisor from holding proxies as the proposal before the meeting would be his but rejected it as unnecessary and impractical.

Adjournments of meeting

16.25 In a case where the provisional supervisor is satisfied that he will complete the formulation of a plan, a meeting may be adjourned to allow the provisional supervisor time to modify a plan for a voluntary arrangement or to apply for the extension of provisional supervision. There should be no other reason otherwise for adjourning the meeting.

16.26 Where the provisional supervisor believes that he will be able to complete a plan but not within the 6 months, the meeting of creditors called to consider the matter may adjourn the meeting to a later date, not exceeding 6 months, if they resolve to extend the moratorium.

16.27 Where the provisional supervisor, having commenced the formulation of a plan, finds that he is unable to complete the plan, the meeting called to consider the position may adjourn the meeting for 7 days to allow the creditors time to make a proposal or proposals to the provisional supervisor.

16.28 Where the provisional supervisor finds that none of the purposes of provisional supervision can be achieved, the meeting cannot be adjourned.

Voting

16.29 The votes of unsecured creditors should be calculated according to the amount of the creditor's debt at the commencement of provisional supervision. In the case where a liquidator makes the proposal for a voluntary arrangement, the relevant date should be the date of presentation of the winding up petition.[152]

16.30 In the case of secured creditors, votes should be calculated according to the amount of the creditor's debt at the commencement of

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151 Section 21(2)

152 Section 21(6).

provisional supervision.[153]

16.31 For any resolution to pass at a meeting of creditors, approving a proposal or modified proposal there should be 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. We considered proposing the majority in value should be three quarters but followed the Canadian provisions in adopting two thirds.[154] We do not favour a bare majority as the procedure contemplates altering the rights of creditors and there must be a convincing level of acceptance by creditors. We feel that a requirement for acceptance by three quarters in value could discourage a provisional supervisor and could also encourage creditors to hold out in some situations. In respect of any other resolution proposed at a meeting, there should be a majority in number and in value voting on the resolution.

16.32 A comparison with other jurisdictions on voting levels is of limited assistance as each procedure has primary provisions that affect the voting values. The administration procedure under the Insolvency Act 1986, for example provides for a resolution to be passed by a majority in value of those present and voting.[155]

16.33 We note that a problem arose recently under the Insolvency Act[156] in relation to the valuation of unliquidated claims for the purposes of voting at a meeting of creditors. The rule provides that a creditor shall not vote in respect of a debt for an unliquidated amount, or any debt whose value is not ascertained, except where the chairman agrees to put upon the debt an estimated minimum value for the purpose of entitlement to vote. In the case in question,[157] the chairman put a value of one pound on the creditor's claim of over 900,000 pounds, when a valuation of 1,722 pounds would have enabled the creditor to defeat a proposed voluntary arrangement. By putting an estimated value on the claim, the chairman caused the creditor to be entitled to vote and thus be bound by the outcome.

16.34 The creditor succeeded in her claim on the basis that there was a material irregularity in the conduct of the meeting.[158] In a more recent case,[159] the court distinguished a similar set of circumstances and upheld the valuation given by the chairman on the basis that the only agreement that the sub-rule requires is an expressed willingness by the chairman to put an estimated minimum value on the debt. In this case, the chairman had valued a claim in respect of a future entitlement to receive rent at a sum equivalent to one year's rent, for voting purposes.

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153 Section 21(7).

154 Bankruptcy and Insolvency Act 1992, section 54(2)(c) & (d). The votes of secured creditors do not count for the purposes of deciding whether a proposal is accepted.

155 Insolvency Rules 1986, rule 2.28(1) but note rule 2.28(1A).

156 Insolvency Rules 1986, rule 1.17(3).

157 *Re Cranley Mansions Ltd* [1994] BCC 576.

158 Under the Insolvency Act, section 6(1)(b).

159 *Doorbar v Alltime Securities Ltd* [1994] BCC 994, in respect of the same wording as rule 1.17(3) but in respect of rule 5.17(3) of the Insolvency Rules 1986.

16.35 For our purposes, we recognise that the valuation of unliquidated claims is a .practical problem and that it will arise at meetings to consider a proposal for a voluntary arrangement. There is no sacred formula that will satisfy the aspirations of all parties when valuing claims. We therefore propose that any valuation put on an unliquidated claim for the purposes of voting by the chairman should not be overturned by the court provided it is not manifestly unreasonable.

Implementation of creditors' resolutions

16.36 Where a voluntary arrangement plan has been approved by creditors that are still subject to provisional supervision, the provisional supervision should cease and the terms of the voluntary arrangement should take effect. The voluntary arrangement would be binding on every creditor who was entitled to vote at a meeting at which the arrangement plan was approved, and on the company and its members.

16.37 As soon as practicable after his appointment, the supervisor of the voluntary arrangement should:

(a) file certified copies of the voluntary arrangement in the Supreme Court Registry and in the Companies Registry; and

(b) advertise in the next issue of the Gazette and in local Chinese and English language newspapers that the company is under supervision.[160]

16.38 If the provisional supervisor is not also the supervisor of the voluntary arrangement he should be obliged to do all things necessary to facilitate the transfer of office.[161]

[160] Section 22(2).
[161] Section 22(3).

Chapter 17

Consequences of the approval of a voluntary arrangement

Effects of a voluntary arrangement

17.1 Even after a company enters into a voluntary arrangement it will need protection. It should be a condition of every voluntary arrangement that, while it is in effect, the parties to the voluntary arrangement should be prohibited from taking actions that would be to the detriment of the other parties to the arrangement. We propose that:

(a) no creditor bound by the arrangement may commence or continue any winding up proceedings against the company;

(b) no resolution may be passed or made by the members or the directors of the company for the winding up of the company;

(c) no receiver of the company may be appointed by a creditor bound by the arrangement or, if already appointed, no receiver may exercise any powers incidental to the office;

(d) no creditor bound by the arrangement may take any step to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession;

(e) no creditor bound by the arrangement may commence any proceedings, execution, distress or other legal process against the company.[162]

17.2 A voluntary arrangement should only be terminated on the happening of events that are clearly stated in the arrangement. For example, creditors should be able to terminate a voluntary arrangement if the company breaches any of its obligations under the arrangement, such as where the company defaults on scheduled repayments of its debts.[163]

17.3 The implementation of a voluntary arrangement would see a company continuing to do business as it would be in the interests of the creditors bound by the arrangement that the company prospers. This should act as an incentive for these creditors to do new business with the company.

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162 Section 23(I).

163 Section 23(2).

17.4 We believe, however, that all those who do business with a company in supervision should be made aware that a voluntary arrangement is in operation. Once a voluntary arrangement comes into effect every invoice, order for goods or business letter issued in the name of the company should contain a statement that the company is in supervision and is subject to a voluntary arrangement. If the company fails to make such a statement on its business documents it should be subject to a fine.[164]

17.5 Any creditor not bound by the arrangement should not be prevented from taking any action or other process available to him against the company.[165]

164 Section 23(4).
165 Section 23(3).

Chapter 18

The supervisor of a voluntary arrangement

18.1 The supervisor of a voluntary arrangement should have the same qualifications as the provisional supervisor, and will probably be the provisional supervisor. Thus, in the absence of a regime of registered insolvency practitioners, an accountant or a solicitor of the Supreme Court of Hong Kong who has a current practising certificate, or a liquidator who acted as provisional supervisor, may act as supervisor of a voluntary arrangement.[166]

18.2 A supervisor of a voluntary arrangement should perform such duties and functions and have such powers as may be specified in the arrangement and ascertain on behalf of the creditors that the arrangement is being adhered to and implemented by the company in accordance with its terms. The supervisor should supervise the arrangement having regard to the interests of the creditors of the company, the company itself and the shareholders of the company.[167]

18.3 The supervisor may require any officer of the company or any employee of the company who in his opinion is capable of giving the information required to provide such information about the business, property, affairs or financial circumstances of the company as the supervisor may reasonably request.[168]

18.4 The supervisor should have access to the premises and all books and records of the company upon reasonable notice and may examine any officer or employee of the company as to the affairs of the company. Any officer or employee of the company who fails to comply with any request from the supervisor should be guilty of an offence.[169]

18.5 The supervisor should be able to apply to the court for directions in relation to any particular matter arising in connection with his functions, duties and powers under the arrangement.[170]

18.6 If any party to the voluntary arrangement is dissatisfied by any act, omission or decision of the supervisor, that party should have the right to make an application to the court. The court should have the power to confirm, reverse or modify any act or decision of the supervisor, give the supervisor

166 Section 30(1).
167 Section 30(2).
168 Section 30(3)(i).
169 Section 30(3) and (4).
170 Section 30(5).

directions, remove the supervisor from office or make any other order it thinks fit.[171]

Vacation of office

18.7 Every voluntary arrangement should make provision for the resignation and removal of the supervisor and for his replacement in the event of such, or of his death, mental incapacity or ineligibility to act as supervisor.[172]

18.8 Where it is expedient to appoint a person to carry out the functions of a supervisor and it is inexpedient, difficult or impracticable for an appointment to be made without the assistance of the court, the court may, on the application of the company, the directors of the company or any creditor of the company, make an order appointing a supervisor of a voluntary arrangement, either in substitution for the existing supervisor or to fill a vacancy.[173]

18.9 If a new supervisor is appointed or if the voluntary arrangement ceases to have effect, the new supervisor or the last supervisor, as the case may be, should file a notice of appointment of new supervisor or notice of cessation of voluntary arrangement in the Supreme Court Registry and the Companies Registry within 14 days.[174]

171 Section 30(6).
172 Section 31(1).
173 Section 31(2).
174 Section 32(1) and (2).

Chapter 19

Insolvent trading

Introduction

The main features

19.1 We propose the introduction of a new provision which would impose a liability for insolvent trading on certain responsible persons,[1] that is, (i) directors and (ii) senior management of a company which act in the place of or on behalf of the directors or who take decisions which directors might normally be expected to take. Responsible persons would become subject to liability for insolvent trading once a company traded while insolvent or if the company continued to trade when there was no reasonable prospect of preventing the company becoming insolvent.

19.2 We propose that two presumptions should be introduced, the effect of which would be to raise a presumption of insolvent trading which would put the onus on the responsible persons to rebut them. The presumptions would be: (i) a presumption of continuing insolvency, and (ii) a presumption of insolvent trading where proper accounts and records of a company have not been kept.

19.3 The new provision would include defences which responsible persons could employ to show that they were not trading while insolvent or that every step had been taken to prevent insolvent trading. The defences would also serve as guide for responsible persons on how to act when a company trades into difficulties.

The reasoning

19.4 A provision imposing liability for trading while a company was insolvent should not be so harsh as to discourage responsible persons from taking the time to consider, and to seek advice, as to whether a company could be saved or go into liquidation; nor should the provision make responsible persons more inclined to push companies into voluntary liquidation or receivership unnecessarily, for fear of being made liable for trading while insolvent. Nonetheless, responsible persons would have to tread a delicate path between being perceived to having attempted to save a company or to having traded while insolvent.

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[1] See paragraphs 19.12 to 19.24.

19.5 The purpose of an insolvent trading provision would be to encourage responsible persons to face the fact that a company was slipping into insolvency at an early date and cause them to address the situation rather than to trade on regardless of the consequences. Insolvent trading should raise the awareness of responsible persons of their duty to creditors rather than just having regard to the interests of the shareholders. Responsible persons who pay attention to their business, and who take appropriate action when faced with insolvency, should never face an application in respect of insolvent trading, whereas those who do not would be vulnerable to an application.

The costs involved in an application for insolvent trading

19.6 We do not expect that there would be a flood of application by liquidators for orders for insolvent trading. Experience in the United Kingdom, in respect of the wrongful trading provisions in the Insolvency Act,[2] has shown that applications are not all that common and that liquidators have to take the costs of taking proceedings into account when considering an application. In addition to deciding whether an application is likely to succeed, a liquidator would have to consider whether a responsible person would have assets to meet any order that may be made.

Insolvent trading to be a civil remedy only

19.7 A provision that rendered a person both civilly and criminally liable would probably result in the courts being reluctant to apply anything other than a criminal test to the civil side of the provision which would make the provision as difficult to prove as fraudulent trading is at present. This problem was noted in the Cork Report which, commenting on fraudulent trading under the Companies Act 1948,[3] stated that the section not only created civil and personal liability, it also created a criminal offence, with the constituent element of the two being identical. As a result, the courts consistently refused to entertain a claim to civil liability in the absence of dishonesty, and moreover, insisted on a strict standard of proof.[4] The Insolvency Act subsequently introduced a separate wrongful trading provision which employs a lower standard of proof than fraudulent trading.

Insolvent trading should only apply once a company goes into liquidation
Only the liquidator should be able to make an application for insolvent trading

19.8 We can see no reason for making an application for insolvent trading unless a company has gone into insolvent liquidation. In practical

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2 Insolvency Act 1986, section 214.
3 The Companies Act 1948, section 332.
4 The Cork Report, paragraph 1776.

terms, there would be no one, such as a liquidator, who would be in a position to form a view that insolvent trading had taken place and to pursue the matter though the courts.

19.9 We consider that the power to make an application should vest in the liquidator only. It is unlikely that a provisional supervisor would have the time to pursue an application for insolvent trading even if a company had traded while insolvent before his appointment. In any event, if provisional supervision failed and a company went into liquidation, it would be a matter for a liquidator at that stage to consider insolvent trading.

19.10 Under the parallel new Australian provisions,[5] it is possible for creditors to make an application for insolvent trading, with or without a liquidator's consent, in certain circumstances. We are of the view that creditors would have the opportunity to press the liquidator to make an application either at a meeting of creditors or through a committee of inspection. In this respect, insolvent trading would be treated in the same manner as any other potential source of revenue to the estate of the company. To treat insolvent trading differently could encourage individual creditors to use insolvent trading to harass responsible persons. We consider that a measured approach is required and that the decision whether to make an application should be made on the basis of the chances of recovering compensation from responsible persons for the benefit of the company and not for revenge.[6]

Model Bill

19.11 As with provisional supervision, we found it of assistance to work with a model Bill, which is annexed as an aid to understanding the proposals.[7]

Directors and senior management should be liable as responsible persons

19.12 We propose that directors and senior management should be responsible persons who would be liable to pay compensation to the company if they are found by the court to have permitted a company to trade while insolvent.

(i) Directors

19.13 We are convinced that directors of a company should be liable under any insolvent trading provision. The difficulty is in pinpointing who should be considered to be a director of a company for the purposes of

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5 Corporations Law, sections 588R to 588U.

6 See paragraphs 19.64 to 19.69 on indemnity and assignment of debts.

7 See sections 34 to 38 of the model Bill.

insolvent trading and then making the provision effective against them. We have taken a broad approach to as to who should be considered to be a director as we want to prevent directors, or those who act as directors, avoiding liability with the defence that they were not actually appointed as directors.

19.14 Insolvent trading should apply to all directors whether they are validly appointed directors, persons who hold themselves out to be directors though they have not been validly appointed, and shadow directors.[8]

19.15 We propose that any provision on insolvent trading should define directors in sufficiently broad terms to include persons who hold themselves out to be directors. Under the Companies Ordinance, section 2, director is defined in the following terms:

> *"includes any person occupying the position of director by whatever name called".*

19.16 The Companies Ordinance, section 168C, defines a shadow director as:

> *"in relation to a company, means a person in accordance with whose directions or instructions the directors of a company are accustomed to act but a person shall not be considered to be a shadow director by reason that the directors act on advice given by him in a professional capacity".*

The definition is, however, limited in its application to Part IV A of the Companies Ordinance, which provides for the disqualification of directors. We propose that this definition be extended to any provision on insolvent trading.

19.17 It is common for a board of directors to be made up of executive directors, that is directors who are also employed by the company in management positions, and non-executive directors, that is directors who are not involved in the day to day management of the company. Non-executive directors are appointed for a variety of reasons, for example, as representatives of large shareholders in a company or for the prestige value of having a particular person as a member of the board. The fact that a non-executive director did not take part in the day to day management of a company should not be a defence against liability under the provision. Anyone who accepts a directorship of a company has an obligation to ensure that he is kept informed of the financial position of the company. It should not be necessary for non-executive directors to have the financial position at their fingertips when a company is solvent and trading normally. When a company begins to trade into difficulties, however, all directors should be aware of the situation and, as a consequence, exert tighter control on a company's day to day operations. This view reflects, we believe, a trend towards higher expectations of directors in the way they conduct their business.

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[8] These three categories of director were identified by Millett J. in re *Hydrodan (Corby) Ltd (1994)* BCC 161.

19.18 Another practice common in Hong Kong is the appointment of nominee companies as directors of companies. If a company that had a nominee company on its board went into insolvent liquidation, a liquidator would be able to look to the individuals behind the nominee company in respect of an application for insolvent trading.

19.19 We anticipate that boards of directors will not always agree that a company is trading into insolvency and that some directors, whether because of their particular expertise or for other reasons, will anticipate the problem before the rest of the board. Such directors would face a dilemma as to what to do. We consider that prescient or dissident directors should be encouraged to stay on the board rather than resign. In any event, it is possible that such a director would be an executive director with an employment contract with the company and could be tied to a notice period which would prevent an early resignation.

19.20 We propose that liability for insolvent trading should not be collective and that, in considering applications against directors, liquidators should take account of a director's actions prior to liquidation. In this regard the ability and expertise of a director would be taken into account.[9] A dissident director should, therefore, be able to protect himself by showing that he had warned the board about insolvent trading and that he had opposed the course of action the company had taken which resulted in insolvent liquidation.

(ii) Senior management

19.21 The exposure to liability of the senior management of a company is a more difficult concept. We consider that senior management of a company, whether or not they are directors, who are involved in the day to day management of the company, should shoulder equal liability for insolvent trading. We have described senior management above as that management of a company which acts in the place of or on behalf of the directors or who take decisions which directors might normally be expected to take.[10] In short, we would make the top decision makers among senior management liable for insolvent trading if they failed to take appropriate action when a company was trading into insolvency.

19.22 It is also desirable in the context of business practice in Hong Kong to include senior management in the provision, as it is common for overseas companies with subsidiary companies in Hong Kong to leave locally appointed management in control of local operations. It is likely that many subsidiary companies seldom hold board meetings and that overseas parent companies rely on reports from local management to keep track of how a Hong Kong subsidiary is faring. In such cases, liability for insolvent trading could lie with both the directors and the senior management as the directors would be liable for their omission in not monitoring the company's operations

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9 See section 36(2)(b).

10 See paragraph 19.1.

and the senior management would be liable for failing to prevent the company from trading while insolvent.

19.23 We consider that no further definition of senior management is necessary as it should be left up to the court to decide whether a person was a senior manager and thus potentially liable to a claim for insolvent trading.

19.24 Senior management may know the day to day financial position of a company as well as the directors. If senior management finds that a company is in danger of trading into a situation of insolvency, it should warn the directors as soon as possible. Provided senior management takes appropriate action in warning the directors and in advising the directors on appropriate action, they should not be liable for insolvent trading. If the board of directors then fails to take appropriate action and instructs senior management to take a course of action that results in insolvent liquidation, senior management should not be liable. Again, as with the prescient director, senior management should document its opposition to such a course of action. It may be appropriate for senior management to resign in such a situation as they would have to think of their future prospects, which might not be helped by being seen to have participated in a disastrous course of action, even if they were opposed to it. Whether senior management resigns or remains with a company, they should be careful to document their actions from the moment that they anticipated insolvent trading, as resignation alone might not constitute an adequate defence.

(iii) Valuation of a company's assets

19.25 If responsible persons are to be subject to liability for insolvent trading, it must be clear how assets should be valued at the time the company traded while insolvent, as different methods of valuing assets and liabilities of a company could reach different conclusions. The valuation of a company on the basis of its book assets, for example, might fail to show that the written down value of property owned by the company was significantly undervalued in terms of its actual market value. If the book value was applied in such a case it would work to the detriment of responsible persons. We would prefer to value a company on the basis of the market or realisable value of its assets in the normal course of business at the relevant time. This would be of benefit to responsible persons as they would be sure of the basis on which they would be expected to value a company. It would also operate to prevent responsible persons trying to inflate the book value of assets to avoid liability for insolvent trading.[11]

Responsible persons' duties [12]

19.26 We do not believe that it is possible to define comprehensively

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11 Section 34(2).

12 Section 34.

the duties of a responsible person. For this reason we have adapted wording from the Insolvency Act [13] and the Australian Corporations Law [14] which provides a broad, fact based, criteria which the courts could refine through a body of decisions.

19.27 The provision first sets out the factual conditions which must be established before an application for insolvent trading can be considered. The facts that a liquidator would need to establish are (i) that a responsible person is or has been responsible person of an insolvent company at the time when the debt or debts were incurred and that (ii) the company was insolvent at that time or there was no reasonable prospect of avoiding becoming insolvent.[15]

19.28 A liquidator must then consider whether a responsible person, at that time, (i) knew the company was insolvent, or (ii) ought to have known that the company was insolvent or would so become, or (iii) that there were reasonable grounds for suspecting that the company was insolvent or would become insolvent and failed to take action to prevent the company from incurring the debt.[16] A director is, therefore, to be judged by an objective standard of the reasonable director even though he is lacking or below average in knowledge, skill or experience, but by his own standards, if, for example, his qualifications and experience are above average. In this case it is also necessary to have regard to the particular company and its business. The qualities required would be less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it would be in a large, sophisticated, company.[17] The first two limbs of this provision am adapted from the Insolvency Act and the third limb is taken from the Australian provisions.

19.29 The third limb set out in the previous paragraph refers to reasonable grounds for suspecting insolvency. A responsible person would be considered to have suspicions if, (i) he was aware at the time that there are grounds for so suspecting, or (ii) if a responsible person in a like position in company, in a company's circumstances, would be so aware.[18] The first part of this provides a subjective test, while the second part is an objective test which a liquidator could fall back on if he had difficulty establishing the first part. The objective test would prevent a responsible person from claiming that he had no idea that a company might have been in danger of insolvency when the facts are such that a reasonable person would have known.

19.30 Although the provision refers to the time of a debt or debts being incurred, we consider that, in most cases, the descent into insolvency is a progression and is not usually limited to one particular debt. That is why we emphasise that responsible persons should be able to anticipate insolvency and act before it bites. Nevertheless, there has to be a particular time when a

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13 Insolvency Act, section 214.
14 Corporations Law, section 588G.
15 Section 34(1)(a).
16 Section 34(1)(b).
17 *Re Produce Marketing Consortium Ltd* (No. 2) [1989] BCLC at 550.
18 Section 34(3).

company becomes insolvent, even though the company may move in and out of insolvency after that time.

Presumptions[19]

19.31 We borrowed the idea of imposing presumptions from the recent Australian provisions.[20] There are two main presumptions, that of continuing insolvency and of failing to keep proper accounts. While there is no corresponding presumptions provision under the Insolvency Act, it effectively provides a presumption that a company has gone into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of winding up.[21] We like the concept of presumptions and consider that they would be a benefit to liquidators in that, if established, they shift the burden of proving the contrary to the responsible persons. In addition, presumptions that are set out clearly in legislation would provide a touchstone for directors as to how they should exercise their duties and responsibilities.

(i) Presumption of continuing insolvency

19.32 The effect of a presumption of continuing insolvency is that, if it is proved that a company was insolvent at a particular time during the 12 months ending on the date of commencement of its winding up, it would be presumed that the company was insolvent throughout the period beginning at that time and ending with the winding up of the company.[22] This would prevent responsible persons defending an application for trading while insolvent by claiming that the company was actually solvent at a particular date, or for a certain period, during the period between the date when insolvency is shown and the date of winding up.

19.33 Where circumstances of insolvency are established as having existed at a particular time within 12 months of winding up, it would shift the burden of proving the contrary on to the directors.

(ii) Presumption of failing to keep proper accounts

19.34 We propose that, if it is proved that a company has contravened section 121 of the Companies Ordinance by failing to keep proper accounting records that report and explain:

(a) its transactions and financial position during the 12 months before winding up, or

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19 Section 35.
20 Corporations Law, section 588E.
21 Insolvency Act 1986, section 214(2) and (6).
22 See the Corporations Law, section 588E and section 35(2).

(b) by failing to keep such accounting records in the manner prescribed by section 121(2) of the Companies Ordinance, or

(c) if the company has contravened section 121(3A) of the Companies Ordinance, by failing to retain such accounting records for the period required by that section;

there should be a presumption that the company was insolvent throughout the relevant period.[23]

19.35 It is a common feature in winding up for a liquidator to find that the accounts and records of a company are incomplete or non-existent. We consider that a presumption of continuing insolvency in relation to accounts and records would be reasonable and would remove a major stumbling block for liquidators who have to deal with responsible persons who hide behind incomplete or non-existent accounts. The presumption would place responsible persons who fail to keep proper accounts in a situation where an application could be made against them for insolvent trading. The only defence to the presumption, apart from those set out in the following paragraphs, is for a responsible person to keep, and be able to produce, proper accounts.

19.36 The Australian provisions allow a defence for individual directors if they can show that a contravention was due solely to someone destroying, concealing or removing accounting records and that the action was not by the director and that the director was not party or in any way concerned with the concealing or removing the records. We consider that this provision would be fair to responsible persons who were innocent of any mischief done in relation to the accounts and propose that it should be adopted.[24]

19.37 The Australian provisions allow an exemption to the presumption for minor or technical breaches in relation to the accounts. This provision is reasonable, though we doubt that a liquidator would make an application unless the contravention was material. Nonetheless, we would not like to see responsible persons hiding behind the exemption and would clarify that a minor or technical contravention would be one that did not materially distort the accounts and records.[25]

(iii) Presumptions of "balance sheet " and/or "cash flow " insolvency are not proposed

19.38 The Harmer Report [26] proposed a presumption that circumstances of insolvency exist at a particular time where it can be shown that the liabilities of a company, inclusive of prospective and contingent liabilities, exceeded its assets at that time, and that there be a similar

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23 See section 35(3).
24 See section 35(5).
25 See section 35(4).
26 The Harmer Report, paragraphs 295 and 296.

presumption where current liabilities exceeded current assets and there were insufficient assets reasonably capable of being realised or charged so as to enable the company to pay its current liabilities.

19.39 The Harmer Report noted that submissions on its original proposal, of a balance sheet presumption, had raised problems of quantifying contingent and prospective liabilities and of the valuation of intangible assets, such as goodwill and copyright. The Harmer Report acknowledged that quantification of contingent liabilities was a problem, and specifically referred to contingent and prospective liabilities in its recommendation, but noted that it could be dealt with by the courts. It was also submitted that a majority of businesses trade on a ratio of assets to liabilities (particularly current assets to current liabilities) of less than one, but the Report noted that a director would have a defence if there was a reasonable expectation that a company would be able to pay its debts.

19.40 This recommendation was not adopted in the Australian provisions, nor do we propose them but we would welcome comments. For the purposes of a responsible person's defence, however, the balance sheet test is applicable, namely that a company is insolvent if in the course of its business its assets are insufficient to discharge its debts and other liabilities in full as they fall due.[27]

Defences[28]

19.41 We consider that, just as we propose statutory presumptions, there should also be statutory defences, as is the case under the Australian provisions [29] and under the Insolvency Act.[30] The effect of an order against responsible persons for insolvent trading could be severe. It is appropriate, therefore, to provide comfort to responsible persons by setting out defences. To maintain a defence, a responsible person would have to demonstrate that he took appropriate action once he saw the problems that a company faced and that he saw the problems in good time.

19.42 A responsible person should have a defence to an application against him for insolvent trading if he can satisfy the court that, at the time when he knew or ought to have known that the company was insolvent or would become so or that there were reasonable grounds for suspecting that the company was insolvent or would become insolvent,[31] he took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken. We note that the British Parliament adopted the phrase "took every step" deliberately as it rejected an amendment that a director should take "every reasonable step". It would be our intention that, provided a responsible person acted in a bona fide manner to minimise the loss, he

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27 See section 34(2).

28 Section 36.

29 Corporations Law, section 588H.

30 Insolvency Act 1986, section 214(3).

31 See section 34(1)(b).

would be protected from an action for insolvent taking, even if his efforts proved to be unsuccessful.

19.43 For the purposes of the defence, the facts which a responsible person ought to have know or ascertain, or the conclusions which he ought to reach and the steps he ought to take, are those which would be known and ascertained, or reached or taken, by a reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that responsible person in relation to the company, and the general knowledge, skill and experience that responsible person has.[32]

19.44 In addition, we propose that, in determining whether the defence[33] has been proved, the onus being on the director, the matters to which regard is to be had include, but are not limited to, any action the responsible person took with a view to appointing a provisional supervisor of the company, when the action was taken, and the results of that action.[34]

19.45 There has been criticism of the Insolvency Act provision.[35] It has been noted that it avoids giving any concrete meaning to the concept of "insolvent trading" or any positive guidance as to the types of conduct which would lead to liability. It has been argued that this is a major gap in the law which would have to be filled by decision of the courts in future test cases.[36] We have no difficulty with this though, and have avoided defining insolvent trading, preferring a provision that would be sufficiently flexible for development by the courts.

19.46 The proposed new provisions do not specify what action a responsible person ought to take when a company is threatened by insolvency. We consider that responsible persons, faced with such circumstances, should document their activities and, in the event of a divergence of opinion, their objection to the action taken or proposed. A director who, for example, argued unsuccessfully that a company should be put into receivership, provisional supervision or voluntary liquidation, could resign to protect himself from personal liability for insolvent trading, but we would prefer that such a director stay with the company and see the matter through. Resignation alone would not absolve a director from liability, but a clear record of urging that appropriate action be taken should protect a director.[37]

19.47 The dilemma that a responsible person would face is unavoidable and goes to the whole issue of what a company should do if it is trading into a position of insolvency. We are aware that responsible persons might take the view that it would be possible to find fresh funding or be taken over on more favourable terms if it remained outside a formal structure for re-

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32 Adapted from the Insolvency Act 1986, section 214(4) and see section 36(2) of the model Bill.

33 That is, the defence under section 36(1).

34 Section 36(4).

35 See paragraph 19.40.

36 Comment from the Annotated Guide to the Insolvency Legislation, (1986), Sealy and Milman, 4th edition, at page 256.

37 See paragraph 19.19.

organisation (provisional supervision). That would be a matter for them. Once a company becomes insolvent, however, it uses money and assets that are not its own and the terms of our proposal are clear: if the responsible persons do not take every step to minimise the potential loss to creditors they would face personal liability for their actions.

19.48 We propose that, provided a liquidator can show that the company has been wound up, that it was insolvent and that the responsible person was a responsible person at the time the company became or was about to become insolvent, the onus of proving that he took every step to minimise the potential loss should rest on that person if application for insolvent trading is made against him.

19.49 The Insolvency Act provides that the functions carried out by a director,[38] include any functions which he does not carry out but which have been entrusted to him, thus placing acts of omission in the same category as acts of commission. It describes the provision as a departure from the common law, which has never had effective sanctions to penalise passive defaults such as non-attendance at board meetings.[39] Nonetheless, we propose adopting the provision as omissions or inaction by responsible persons in the context of an application for insolvent trading should not be a defence. A responsible person should not be able to claim, for example, that he did not know a company was trading while insolvent because he had not attended meetings of the board of directors or if a senior manager did not know the financial position of the company.

The Australian defences

19.50 We considered adopting the Australian defences provision which provided for four specific defences. The defences are:

(i) If it is proved that, at the time when the debt is incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

(ii) If it is proved, without limiting the generality of (i), that at the time when the debt is incurred, the person had reasonable grounds to believe, and did believe that a competent and reliable person was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and that the other person was fulfilling that responsibility; and expected, on the basis of the information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred

38 The Insolvency Act, section 214(4) and see section 36(3) of the model Bill.
39 The Annotated Guide, 4th edition at page 257.

that debt and any other debts that it incurred at that time.

(iii) If because of illness, or for some other good reason, the person did not take part at that time in the management of the company.

(iv) If the person took all reasonable steps to prevent the company from incurring the debt.

19.51 There are similarities between the Insolvency Act and Australian provisions, such as that the onus of proof should be on the directors and that a director should show that he took action to prevent the incurring of the debt to minimise the damage. We consider that the Insolvency Act provides a more objective test than the first Australian defence which is an untested provision and may be difficult to prove. We do not favour the second Australian provision which would allow a director to place responsibility on a competent and reliable person to provide adequate information. In any event, it would not complement our proposals on senior management.

19.52 We feel that the third defence, of illness, would also be open to abuse. If a director was so ill that he could not take part in the management of a company during the critical period when a debt was incurred, we doubt that any liquidator would risk, or want to, make an application against that director for insolvent trading, especially when the costs involved in making such an application are taken into account.

Expenses of winding up

19.53 For the purposes of defining insolvent liquidation,[40] we have not included the expenses of the winding up. This differs from the corresponding provision under the Insolvency Act,[41] which includes the expenses of the winding up with the liabilities and debts. We consider that responsible persons need as much certainty as possible in calculating a company's assets and liabilities and, as it is unlikely that responsible persons would consider the expenses of winding up when struggling to keep a company in business.

Responsible persons may be liable to compensate the company[42]

19.54 We propose that if the court finds that a responsible person is liable for trading while insolvent, it should be able to order the responsible person to pay compensation to the company equal to the amount of that loss or such other sum as the court thinks fit.

19.55 The provision would have effect in addition to any rule or law

40 Section 34(2).
41 Insolvency Act, section 214(6).
42 Section 34(4).

about the duty or liability of a director through his office or employment in relation to the company and would not prevent proceedings from being instituted in respect of any breach of such a duty or liability.[43]

Contributions by responsible persons should be compensatory

19.56 The provision would provide for a payment by a responsible person, or responsible persons, of an amount sufficient to cover the loss to the company from insolvent trading. The primary purpose of the provision would be compensatory and could include the costs and expenses involved in pursuing the responsible persons for insolvent trading. Although the court would have a discretion as to the amount to be awarded, it is not intended that the court should award punitive amounts. This is the case at present under the wrongful trading provisions of the Insolvency Act, though it has been noted[44] that the Insolvency Act wording gives the court a wide discretion in this regard.[45]

19.57 It should be left to the discretion of the court to decide the amount of compensation that should be awarded as the actions of each responsible person would have to be judged separately. If several responsible persons were found to be liable for insolvent trading, it would be up to the court to decide the level of contribution that should be payable by each responsible person. If a responsible person found liable did not have sufficient assets to pay compensation and other responsible persons did have assets, the court would have the discretion to order those responsible persons with assets to pay the full amount of the loss. It would also be open to a liquidator to take action only against those responsible persons who had assets rather than to waste time and money pursuing responsible persons who had no assets. In this respect, if just one responsible person has the assets to pay compensation to the company, he should not be able to claim that he should only be liable pro rata with other responsible persons who were also liable, but unable to pay.

How recovered contributions should be applied

19.58 It is necessary to consider whether amounts recovered should go into the general assets in the hands of the liquidator or whether they should go to relieve unsecured creditors.

19.59 If, for example, there is a floating charge over the assets of the company it could secure all the available assets of the company, in which case the amount recovered would go to benefit the secured creditor, leaving general unsecured creditors with nothing. This point was addressed by the Harmer Report, which recommended that an amount recovered in an action

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43 Corporations Law, section 588P and see section 34(6) of the model Bill.

44 Knox J in *re Produce Marketing Consortium Ltd* (1989) 5 BCC at 569 and 597. It is worth noting that a punitive element has been awarded in an action for fraudulent trading under section 213 of the Insolvency Act, which has similar wording in terms of the discretion of the court to order a contribution to company assets. See *re Cyona Distributors* Lid [1967] Ch. 889.

45 Insolvency Act 1986, section 214(1).

for breach of duty be available for distribution only among unsecured creditors.[46]

19.60 The Cork Report[47] noted that the court should have flexibility with regard to the beneficiaries of any award but made no specific recommendation, nor was provision made in the Insolvency Act. The issue was addressed by the English courts in the *Produce Marketing* case, where the court appears to have assumed that the floating chargee would have a charge over the amounts paid as contributions by directors. The decision has been criticised and it has been suggested that taking such an approach could defeat the purpose of the provision.[48]

19.61 Complicating the issue is the fact that some creditors might have known that the company was insolvent when the debts were incurred but took the risk of trading or even that debts incurred at different times by the same creditors were incurred with different levels of involvement. The Cork Report described the possible diversity as endless.[49] This argument is particularly relevant to creditors with a floating charge, usually banks, as their officers often have knowledge of the true financial position of a company.

19.62 While we have sympathy for the plight of ordinary creditors, we consider that there is no reason to interfere with the rights of secured creditors. We propose, therefore, that if the other security available is insufficient to satisfy the amount owed to the holder of a floating chargee, any amount recovered as compensation for insolvent trading should first be applied in satisfaction of the claims of the secured creditor.

19.63 Where, however, a creditor or creditors knew that the company was insolvent at the time that a debt was incurred, or was likely to become insolvent, the court should have the discretion to order that any compensation paid to the company should not be available to that creditor or creditors in relation to the incurring of that debt unless all the company's debts, whether secured or unsecured, have been paid in full.[50]

Funding of application or indemnity by creditors

19.64 A further issue concerns the funding of an application by a creditor which results in a contribution being made by a responsible person. We consider that it is reasonable that such a creditor should receive an additional amount over and above its rights in a pari passu distribution. Notwithstanding that there might be a floating charge over the company, we propose that any creditor or creditors who indemnify an application by the liquidator should be entitled to receive an additional payment that reflects the risk run in providing the indemnity. We note that the Companies Ordinance[51]

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46 Harmer Report, paragraphs 320 and 321.
47 The Cork Report, paragraph 1797 and 1806(4).
48 Hicks, The Company Lawyer, Vol 14, No. 1 at page 19. See also the Annotated Guide, 4th ed. at page 255.
49 The Cork Report, paragraph 1797.
50 Section 38.
51 The Companies Ordinance, section 265(5B).

provides that, where in any winding up assets have been recovered under an indemnity for costs of litigation given by certain creditors, the court may make such order as it deems just with respect to the distribution of those assets and the amount of those expenses so recovered with a view to giving those creditors an advantage over others in consideration of the risk run by them in so doing.

19.65 The position was recently considered in the High Court in Hong Kong in a case[52] where the court made an order for a greater share to be paid to an indemnifying creditor in respect of a recovery of assets. The court noted that, as the section creates an exception to the general rule of pari passu distribution it should be construed strictly, and provided guidance as to the principles upon which the court should act. These are:

(i) Encouragement should be given to those willing to assist liquidators in recovery of assets.

(ii) The advantage given to the indemnifying creditor over other creditors is in consideration of the risk run by them in providing that indemnity. There must, therefore, be some matching of the risk as against the reward attained.

(iii) Where possible, all creditors should be given an opportunity of indemnifying the liquidator, so that no creditor gets an unfair advantage.

19.66 We agree with the court and, as the provision applies to a company that is being wound up, we see no reason to recommend any change to the law in this regard. We also propose that an order to pay compensation in respect of insolvent trading should be enforceable as if it were a judgment of the court.[53]

19.67 We do not propose that creditors should be able to make an application to the court in respect of insolvent trading. We consider that the position is adequately covered by the present provisions of the Companies Ordinance which, as mentioned above, allow creditors to indemnify the liquidator in respect of an application to the court if an indemnity is sought. Furthermore, a creditor is entitled to question a decision of a liquidator not to make an application, either at a meeting of creditors or through the committee of inspection, if one has been appointed.[54]

Assignment of application

19.68 A liquidator has the power under the Companies Ordinance to

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52 *In re Intertrans Far East Ltd* Companies, Winding Up No. 195 of 1986, Rogers J. Ruling given on 28th December 1993.

53 Section 34(5).

54 See sections 199 and 200 of the Companies Ordinance.

assign the right to an action to a creditor or other party.[55] In the case of insolvent trading, however, we consider that an application should remain personal to the liquidator and that he should not have the power to assign. Our reasoning is that a liquidator, in considering an application in respect of insolvent trading, is not dealing with a common debt. He must decide whether a responsible person has laid himself open to an application for insolvent trading. If an application proves successful, it could have consequences for the responsible person far greater than any amount of compensation he may have to pay. An order against a director for insolvent trading could result in his being disqualified from acting as a director. A senior manager would have his chances of future employment in industry severely compromised. The potential damage to a responsible person is, therefore, too serious to allow a liquidator assign the application in the hope of a pay out under the terms of the assignment.

Director may be disqualified for insolvent trading

19.69 If the court makes a declaration that a responsible person, whether he is a director or senior manager, is liable to pay compensation for insolvent trading, the court should have the discretion to make an order disqualifying that person from being a director of any company under part IV A of the Companies Ordinance. The proposal follows a parallel provision in respect of disqualification for fraudulent trading under section 168L of Part IV A of the Companies Ordinance, which provides that the maximum period of a disqualification order under the section is 15 years.

Person managing a company while disqualified may become liable for company's debts[56]

19.70 We propose that if a person acted as a director of a company which goes into insolvent liquidation at a time when he was disqualified as a director under Part IV A of the Companies Ordinance, he may be held liable for the debts of the company.

Transitional

19.71 We consider that an application in respect of insolvent trading should not be retrospective. The date of a company incurring a debt should be the triggering event. If that event occurred before an insolvent trading provision became law, no application should be made for an order against responsible persons.

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55 Companies Ordinance, section 199.

56 Section 37.

Holding companies

19.72 The new Australian law on a director's duty to prevent insolvent trading by a company contains a provision[57] which makes holding companies liable for the insolvent trading of a subsidiary company where:

> *"there are reasonable grounds at the time for suspecting that the subsidiary is insolvent or would become insolvent, and*
>
> *that either the holding company or one or more of its directors were aware of these grounds or, having regard to the mature and extent of the corporation's control over the subsidiary's affairs, it is reasonable to expect that a corporation in the holding company's circumstances would have been aware of those grounds or that one or more of the holding company's directors would have been aware of those grounds."*[58]

19.73 A holding company has a defence if it is proved that, when the debt was incurred, the holding company and each relevant director had reasonable grounds to expect that the company was solvent at the time and would remain so, even if it incurred that debt and any other debts that it incurred at that time. It is also a defence if the holding company and each relevant director believed, on reasonable grounds that a competent and reliable person was responsible for providing adequate information about the solvency of the company and that he was fulfilling that responsibility and that the holding company and the relevant directors expected, on the basis of the information provided, that the company was solvent. A third defence is provided if the holding company can prove that it took all reasonable steps to prevent the company from incurring the debt. Fourth, it is a defence if, because of illness or some other good reason, a relevant director did not take part in the management of the holding company at the time the debt was incurred, even if that director was aware that there were grounds for suspecting that the subsidiary was insolvent.[59]

19.74 We consider that it is neither appropriate nor practical to propose the introduction of the provision on the basis that any provision which seeks to lift the corporate veil should be considered in the overall context of Hong Kong's company law and not in isolation, as would be the case with insolvent trading. We believe that it is worth noting, however, and would welcome comment on the introduction of a provision equivalent to the Australian provision referred to above.

19.75 We would also note that members of the sub-committee were divided in their views on the provision. Several members questioned whether it would be right to lift the veil on inter company relationships under any circumstances. Other members supported the idea; certainly in this limited

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57 Corporations law, section 588V.

58 Reproduced from the Australian Corporation law, Pending Legislation, 3 November 1992, page 222; Butterworth's Australian Corporations Law-Legislation Service.

59 Corporations Law, section 588X.

context. It was noted that, whereas holding companies and their subsidiaries were separate legal entities, people often did business with subsidiaries on the basis of their connection with the holding company even though they would not necessarily know the extent of support the holding company would give its subsidiary on insolvency. It was noted that the debts of subsidiaries are usually covered by cross guarantees from holding companies but this would be of no assistance to the small ordinary creditor. Further, substantial groups of companies typically support their rather than jeopardise the reputation and credit rating of the entire group.

19.76 Finally, about 260 of Hong Kong's listed companies were listed in other jurisdictions and that any attempt to lift the veil on these companies would have extra-territorial implications.

Fraudulent trading under section 275 of the Companies Ordinance

19.77 The insolvent trading proposals, if adopted, would probably have the effect of reducing the role of the current fraudulent trading provision as the standard of proof in fraudulent trading would be higher than the standard proposed for insolvent trading. A similar situation arose in the United Kingdom when wrongful trading was introduced but fraudulent trading remained as a provision of the Insolvency Act.[60]

19.78 There are two main reasons for preserving fraudulent trading for now, but we will consider it further in our final report on the winding up provisions of the Companies Ordinance. First, fraudulent trading contains both a criminal[61] and civil sanction whereas insolvent trading is a civil provision only. Second, it would be wise to preserve fraudulent trading in the event that there are problems in the implementation of insolvent trading.

19.79 Although fraudulent trading is a little used remedy in Hong Kong, it was considered in a recent case when the court set out the standard of proof required.[62] The plaintiff must prove that:

(i) The defendant made decisions which were not in the interests of the company; and

(ii) that they did so with knowledge that at the time of incurring greater liabilities the company was insolvent and in no position to clear its debts.

(iii) If (i) and (ii) are shown by the facts, then fraud or dishonesty could be established by inference, subject to

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60 Insolvency Act 1986, section 213.

61 On indictment (fine unlimited and 5 years); summary ($100,000 and 12 months).

62 *Aktieselskabet Dansk Skibsfinansierung v Wheelock Marden & Co. Ltd*. [15 December 1989] [Jones J] (unreported) (HKLD 1990 A14).

(iv) a subjective test as to the state of mind / motives of the defendants, otherwise what seemed like fraud might only be negligence; and subject to

(v) an objective test as to whether the director fulfilled his duty to preserve the assets of the company, namely: where a director takes a risk in using assets of the company which risk no director could honestly believe to be in the interests of the company and which were prejudicial to the rights of others, then that director was fraudulent.

ANNEXURE

MODEL BILL

PART IV B

PROVISIONAL SUPERVISION

AND

COMPANY VOLUNTARY ARRANGEMENTS

Section

PART IV C

INSOLVENT TRADING

Annexure

MODEL BILL

PART IV B

PROVISIONAL SUPERVISION

AND

COMPANY VOLUNTARY ARRANGEMENTS

Section 1 - Definitions etc

(1) (Definitions)

(2) This Part shall apply only to a company as defined in section 2(1) and Part XI of this (the Companies) Ordinance.

Section 2 - Purposes of voluntary arrangement

(1) The purposes for whose achievement a voluntary arrangement may be made are all or any of the following :

(a) the avoidance of the winding up of the company;

(b) the survival of the company, or the whole or any part of its undertaking, as a going concern;

(c) the satisfaction, in whole or in part, of the debts of the company;

(2) A proposal for a voluntary arrangement may be made whether or not the company is unable to pay its debts.

(3) Without limiting the generality of the purposes specified in sub-section (1) a company may make a proposal for a voluntary arrangement between the company and its creditors for any one or more of the following purposes :-

(a) an extension of time for payment of its debts;

(b) a composition in satisfaction of its debts;

(c) the compromise of any claims against the company;

(d) the variation or re-ordering of the rating for payment of its debts

or any class of its debts;

(e) the conversion of its debts in whole or in part into shares or other securities to be issued by the company;

(f) any other scheme or arrangement in relation to the affairs of the company.

Section 3 - Who may propose a voluntary arrangement

(1) The following may make a proposal for a voluntary arrangement :

(a) before the presentation of a petition to wind up the company to which the proposal relates :

(i) the company, by ordinary resolution; or

(ii) a majority of the directors of the company;

(b) subject to subsection (2), after the presentation of a petition to wind up the company to which the proposal relates, any provisional liquidator of the company.

(2) No proposal for a voluntary arrangement shall be made (without the consent of such office holder) :

(a) after a liquidator of the company has been appointed; or

(b) after a receiver has been duly appointed in respect of the whole or substantially the whole of the company's assets.

(3) A proposal for a voluntary arrangement may be made as an alternative or in addition to a compromise or arrangement under section 166 of this Ordinance or to a compromise, arrangement, reconstruction or any other scheme or arrangement provided for by any other section of this Ordinance.

Section 4 - Provisional supervisor

A proposal for a voluntary arrangement shall include a nomination of a provisional supervisor to act in relation to the proposal.

Section 5 - Who may be provisional supervisor

(1) Where a voluntary arrangement is proposed by the company or the directors of the company the provisional supervisor must be a registered insolvency practitioner [or until such a regime is established either

(a) a professional accountant, or

(b) a solicitor of the Supreme Court of Hong Kong, who has a current practising certificate]

and such person must have agreed to act as provisional supervisor.

(2) Where a voluntary arrangement is proposed by the provisional liquidator in a compulsory winding up of the company he may nominate himself to be the provisional supervisor or he may nominate as the provisional supervisor any person eligible under sub-section (1).

Section 6 - Filing of documents relating to proposal

(1) A proposal for a voluntary arrangement shall not have any of the effects referred to in this Part until the documents specified in sub-section (2) have been filed as required by sub-section (3).

(2) The documents to be filed are :

(a) a copy of the resolution (in the form prescribed) of the company or the board of directors proposing a voluntary arrangement, or, as appropriate, of the proposal in the form prescribed of the provisional liquidator in a compulsory winding up; and

(b) the consent (in the form prescribed) of the provisional supervisor to act as such.

(3) The documents to be filed under this section shall be filed at both the Registry of the Supreme Court and the Companies Registry.

Section 7 - Effect of filing of documents

Upon the filing of all the documents required to be filed under section 6 :

(a) the company shall be in provisional supervision and the provisional supervision period shall commence;

(b) the appointment of the provisional supervisor and the powers and duties of the provisional supervisor shall take effect; and

(c) the moratorium (section 9) shall apply in respect of the company and its creditors.

Section 8 - Gazetting and advertising

As soon as practicable after the appointment of the provisional supervisor takes effect he shall :

(a) cause to be advertised in the next available issue of the Gazette, and

(b) cause to be advertised as soon as possible in one local Chinese language newspaper and one local English language newspaper

notice of the proposal for a voluntary arrangement and that the company is in provisional supervision in the form prescribed.

Section 9 - Stay of proceedings etc (the moratorium)

(1) This section shall have effect subject to section 10 and section 19.

(2) Upon the commencement of the provisional supervision period the provisions of sub-section (9) (the moratorium) shall apply to the company.

(3) The moratorium shall apply for an initial period of 30 days from the commencement of its provisional supervision ("the initial moratorium period").

(4) Thereafter the moratorium may be continued by extensions for a period or periods of a maximum of 30 days (as determined by the court) for each period upon application to the court by the provisional supervisor pursuant to section 19.

(5) The maximum length of the moratorium (including the initial period and any extensions) shall be 6 months from the commencement of the provisional supervision subject to any extensions agreed to by the creditors under section (19).

(6) The moratorium shall cease forthwith :

(a) upon a resolution being passed pursuant to section 17(12); or

(b) upon a resolution being passed pursuant to section 19(14)(b) or 19(18)(b); or

(c) upon a resolution being passed pursuant to section 20(7)(a) or (c) or section 19(18)(b);

(d) upon a deemed winding up pursuant to section 17(13) and section 20(10).

(7) The moratorium shall cease to apply for any class or classes of creditors excluded from an arrangement plan upon the filing of notice of exclusion pursuant to section 18(2).

(8) The moratorium shall cease to apply to a creditor or other person exempted therefrom pursuant to section 19(8) upon the making of the order.

(9) During the provisional supervision period :

(a) no application for the winding up of the company by the court may be commenced or continued;

(b) save for such resolution of a meeting of creditors under this Part, no resolution may be passed for the winding up of the company;

(c) no receiver of the assets of the company may be appointed or if already appointed no receiver may exercise any powers incidental to the office;

(d) no steps may be taken to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession;

(e) no proceedings, execution, attachment or other legal process may be commenced or continued against the company or its property, no distress may be levied (or if already levied no sale thereunder shall be effected) and no right of forfeiture or entry or re-entry may be exercised;[1] and

(f) no agreement or arrangement with the company may be terminated or varied by reason only that the company is in provisional supervision.

(10) Subject to any provisions of this Part to the contrary, sub-section (9) shall apply only in relation to creditors who are at the relevant time subject to the provisional supervision.

(11) Subsection (9) does not apply in respect of an eligible financial contract.

(12) In subsections (11) and (13), "eligible financial contract" means

(a) a currency or interest rate swap agreement,

(b) a basis swap agreement,

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[1] But see paragraph 5.19.

(c) a spot, futures, forward or other foreign exchange agreement,

(d) a cap, collar or floor transaction,

(e) a commodity swap,

(f) a forward rate agreement,

(g) a repurchase or reverse repurchase agreement,

(h) a spot, futures, forward or other commodity contract,

(i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities,

(j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i),

(k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j),

(l) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (k), or

(m) any agreement of a kind prescribed;

"net termination value" means the net amount obtained after setting off the mutual obligations between the parties to an eligible financial contract in accordance with its provisions.

(13) For greater certainty, where an eligible financial contract entered into before the commencement of the provisional supervision period is terminated on or after such commencement, the setting off of obligations between the company subject to provisional supervision and the other parties to the eligible financial contract, in accordance with its provisions, shall be permitted, and if net termination values determined in accordance with the eligible financial contract are owed by the said company to another party to the eligible financial contract, that other party shall be deemed for the purposes of this Part and, where appropriate, any subsequent winding up to be a creditor of the said company with a claim provable in respect of those net termination values.

Section 10 - Right of election of chargeholder over the whole or substantially the whole of the company's assets

(1) This section applies where there is in existence upon the commencement of the provisional supervision period any charge created as a floating charge over the whole or substantially the whole of the assets of the company.

(2) Within two working days of the commencement of the provisional supervision period the provisional supervisor shall give notice in writing in the prescribed form to any such chargeholder notifying such chargeholder that the company is in provisional supervision and requiring the chargeholder to elect in writing to the provisional supervisor in the prescribed form within three days of the receipt of the said notice whether or not such chargeholder will participate in the provisional supervision.

(3) If any such chargeholder elects not to participate in the provisional supervision, the provisional supervision shall cease immediately upon the receipt by the provisional supervisor of such election.

(4) If any such chargeholder elects to participate in the provisional supervision or fails to elect within the said period, the provisional supervision shall continue and the chargeholder shall be subject to the provisions of this Part.

Section 11 - Functions of provisional supervisor

The functions of a provisional supervisor of a proposal for a voluntary arrangement are:

(a) to assess the financial position of the company;

(b) as soon as practicable thereafter, to decide whether or not any of the purposes of a voluntary arrangement are capable of being achieved;

(c) if the provisional supervisor decides that any of the purposes of a voluntary arrangement are capable of being achieved, to formulate, an arrangement plan to achieve any such purpose or purposes;

(d) having formulated such plan, to submit the plan to a meeting of creditors for acceptance or otherwise by the creditors pursuant to section 20. So far as possible, the plan shall be submitted within the initial moratorium period;

(e) if the provisional supervisor, having assessed the financial position of the company, decides that none of the purposes of a voluntary arrangement are capable of being achieved he shall

call a meeting of creditors pursuant to section 17;

(f) during the provisional supervision period the provisional supervisor shall do all things necessary to protect the assets of the company;

(g) subject to the provisions of sections 12 and 13, during the provisional supervision period the provisional supervisor shall manage the affairs, business and property of the company with the primary purpose of preserving the assets of the company for the creditors as a whole;

(h) subject to the above functions, the provisional supervisor shall act in the supervision of the company in the best interests of the company.

Section 12 - Powers and duties of the provisional supervisor

(1) Upon his appointment the provisional supervisor shall take into his custody or under his control all the property to which the company is or appears to be entitled.

(2) The provisional supervisor shall do all such things as may be necessary for the supervision and management of the affairs, business and property of the company.

(3) Subject to his overriding duty to supervise the provisional supervision and his functions under section 11 and without prejudice to the generality of the powers in sub-sections (1) and (2), the provisional supervisor may :

(i) delegate all or any of his powers and duties under this section to all or any of the directors of the company. Such delegation shall be made in writing and may be upon such terms as the provisional supervision thinks fit and such delegation may be revoked by the provisional supervisor in writing at any time as he thinks fit;

(ii) appoint any agent or employ any person to do any business which he is unable to do himself or which can more conveniently be done by an agent or employee and dismiss the same;

(iii) appoint a solicitor or accountant or other professionally qualified person to assist him in the performance of his functions and dismiss the same;

(iv) do all acts and execute in the name and on behalf of the company any deed, receipt or other document;

(v) use the company seal and chop;

(vi) draw, accept, make and endorse any bill of exchange or promissory note in the name and on behalf of the company;

(vii) make any payment which is necessary or incidental to the performance of his functions;

(viii) raise or borrow money and grant security therefore over the property of the company;

(ix) make any arrangement or compromise on behalf of the company;

(x) call any meeting of the members or creditors of the company;

(xi) to disclaim onerous contracts;

(xii) do all things incidental to his functions.

(4) The provisional supervisor also has power :

(a) to remove any director or officer of the company;

(b) to appoint any director or officer of the company, whether to fill a vacancy or otherwise.

(5) The provisional supervisor may apply to the court for directions in relation to any particular matter arising in connection with the performance of his functions and duties or the exercise of his powers.

(6) Subject to section 24, in exercising his powers the provisional supervisor is deemed to act as the agent of the company.

(7) A person dealing with the provisional supervisor in good faith and for value is not concerned to inquire whether the provisional supervisor is acting within his powers.

(8) The provisions of section 268 of the Companies Ordinance shall apply to the provisional supervisor's power to disclaim mutatis mutandis.

Section 13 - The position of the directors of the company

(1) Subject to sub-section (2), during the provisional supervision period the powers and duties of the directors, and each and all of them, shall be suspended and any act or thing required to be done by the directors or any of them shall be done by the provisional supervisor in the name of the company.

(2) Save that by notice in writing in the prescribed form the provisional supervisor may lift such suspension as regards all or any of the directors either generally or in respect of any particular power and duty or powers and duties for such time and on such terms as the provisional supervisor thinks fit, but such lifting may be terminated by notice in writing in the prescribed form as and when the provisional supervisor thinks fit.

(3) During the provisional supervision period the directors or a director, whether as such or as delegates or delegate of the provisional supervisor, shall not allow or permit :

(a) any disposition of any fixed asset of the company;

(b) any payment by the company, other than a payment made in the ordinary course of business and on usual commercial terms;

(c) any charge or security (real or personal) by the company;

(d) any disposition, dealing or payment to a director or to any member of a director's family or to any company or person associated directly or indirectly with a director.

(e) any act, payment or thing to be done not in the ordinary course of business of the company.

(4) A director who allows or permits the company to do any act or thing in contravention of sub-sections (3) shall be guilty of an offence.

(5) A director found guilty of an offence under this section shall be liable

(a) (i) on conviction on indictment, to a fine of $200,000 and imprisonment for 2 years;

(ii) on summary conviction, to a fine of $100,000 and imprisonment for 6 months; and

(b) to contribute to the assets of the company by way of compensation such sum as the court thinks just.

Section 14 - Ascertaining company's affairs etc

As soon as practicable after his appointment takes effect the provisional supervisor shall investigate the business, property, affairs and financial circumstances of the company.

Section 15 - Information and assistance

(1) As soon as practicable after his appointment takes effect the provisional supervisor shall require one or more of the persons specified in sub-section (5) within 7 days following receipt of such request to provide the provisional supervisor with a statement of the affairs of the company.

(2) The statement shall disclose :

(a) particulars of the company's assets, debts and liabilities,

(b) the names and addresses of its creditors;

(c) any securities held by such creditors;

(d) the dates when the securities were respectively given; and

(e) such further or other information as may reasonably be required.

(3) A specified person shall immediately following being required by the provisional supervisor so to do :

(a) deliver to the provisional supervisor all documents and records relating to the company; and

(b) inform the provisional supervisor as to the whereabouts of any such documents and records within the knowledge of that person.

(4) A specified person shall :

(a) attend on the provisional supervisor when reasonably requested so to do; and

(b) provide to the provisional supervisor such information about the business, property, affairs or financial circumstances of the company as the provisional supervisor may reasonably request.

(5) The persons specified for the purposes of this section are :

(a) any past or present officer of the company;

(b) any person who has taken part in the formation, promotion, administration or management of the company within one year before the date of the appointment of the provisional supervisor;

(c) any employee or person who has been employed by the company that year and who in the opinion of the provisional supervisor is capable of giving the information required;

(d) those who are or have been within that year officers or employees of a company which is, or within the year was, an officer of the company.

(6) If a specified person without reasonable excuse fails to comply with a request from the provisional supervisor he shall be guilty of an offence and if found guilty shall be liable to imprisonment and/or a fine[2] and, for continued contravention, to a daily default fine.

(7) A person who is required to make any statement of affairs of a company shall be entitled to all reasonable costs or expenses in or about the preparation or making of the statement; but before incurring any costs or expenses to any other person the person making the statement shall apply to the provisional supervisor for sanction and submit a statement of the estimated costs and expenses. The person making such statement shall be reimbursed his costs and expenses by the provisional supervisor as part of the expenses of the provisional supervision.[3]

Section 16 - Notices for creditors

(1) As soon as possible after his appointment takes effect the provisional supervisor shall cause to be advertised in one local Chinese language newspaper and one local English language newspaper notice to creditors of the company to give notice in writing to the provisional supervisor of their claims within 7 days of the publication of any such advertisement. Provided always that such notice may be included in the advertisements required by section 8.

(2) The provisional supervisor shall cause to be advertised in one local Chinese language newspaper and one local English language newspaper at least 7 days prior to the meeting of creditors to be held pursuant to sections 17 and 20 notice of the meeting and requiring creditors of the company who have not yet submitted their claims to do so in writing at least 2 days before the relevant meeting.

Section 17 - Whether the purpose of a voluntary arrangement are capable of being achieved

(1) As soon as practicable after he has ascertained the financial position of the company pursuant to section 14 the provisional supervisor shall :

(a) assess the financial position of the company; and

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2 We suggest that, on indictment the fine should be $50,000 and 12 months' imprisonment and for a summary offence conviction the fine should be $10,000 and 6 months' imprisonment. The daily default fine would be $500.

3 See rule 43 of the Companies (Winding Up) Rules.

(b) decide whether or not any of the purposes of a voluntary arrangement are capable of being achieved.

(2) Such decision shall be made within the initial 30 days' moratorium period.

(3) If the provisional supervisor decides that any of the purposes of a voluntary arrangement are capable of being achieved, he shall thereupon commence to formulate an arrangement plan under section 18.

(4) In reaching his decision the provisional supervisor may consult with such of the directors and officers of the company, the company's accountants, the creditors and members of the company and any other person or person he thinks fit.

(5) If the provisional supervisor decides that none of the purposes of a voluntary arrangement are capable of being achieved he shall call a meeting of the creditors of the company to report his decision to them.

(6) For the purposes of such meeting the creditors shall form one class.

(7) 7 days notice in writing of the meeting shall be given by the provisional supervisor to all creditors still subject to the provisional supervision of whose claim the provisional supervisor is aware.

(8) The notice of meeting shall specify the time, date and place of the meeting and the purpose of the meeting, namely :

(a) to consider the decision of the provisional supervisor that none of the purposes of a voluntary arrangement is capable of being achieved; and

(b) to decide the action to be taken by the meeting, namely;

(i) to terminate the provisional supervision; and

(ii) to resolve that the company be wound up as a creditors' voluntary winding up and to appoint a liquidator.

(9) The notice of meeting shall inform the creditor to whom it is addressed that the following documents, namely :

(a) a report by the provisional supervisor concerning the business, property, affairs and financial circumstances of the company and any other matters in relation to the company as the provisional supervisor in his discretion considers necessary to enable the creditors to make an informed decision; and

(b) a statement, with reasons, as to the decision of the provisional supervisor as to why he considers none of the purposes of a voluntary arrangement are capable of being achieved,

are available on application therefore to the provisional supervisor or can be inspected at the provisional supervisor's office within normal office hours.

(10) The provisions of sub-sections (1) to (8) inclusive of section 21 shall apply to a meeting of creditors held pursuant to this section.

(11) For any resolution to pass at such meeting or any adjourned meeting there must be a majority in number and in excess of one half in value of the creditors present in person or by proxy and voting on the resolution.

(12) The meeting of creditors shall resolve :

(a) to terminate the provisional supervision; or

(b) that the company shall be wound up and to appoint a provisional liquidator.

(13) If there is no quorum at the meeting of creditors it shall be deemed that the company should be wound up.

Section 18 - Preparation of arrangement plan

(1) The arrangement plan may be in any form whatsoever, save that the plan put to the meeting of creditors hereunder shall be in the form of a draft voluntary arrangement and shall provide for a supervisor of the arrangement.

(2) The provisional supervisor may at any time prior to any meeting of creditors under this Part exclude from the arrangement plan any class or classes of creditors [for whom any alternative arrangements have been made by agreement between the provisional supervisor and such class or classes of creditors] and upon the provisional supervisor filing a notice of exclusion in the prescribed form in both the Registry of the Supreme Court and the Companies Registry the provisions of section 9(9) (the moratorium provision) and the provisional supervision shall cease to apply to such class or classes of creditors so excluded.

(3) In determining the terms of the plan the provisional supervisor may consult with such of the directors and officers of the company, the company's accountants, the creditors and members of the company and such other person or persons as he thinks fit.

(4) Having formulated the plan the provisional supervisor shall call a meeting of creditors to submit the plan to the creditors in accordance with section 20.

Section 19 - Extension of moratorium period

(1) If the provisional supervisor shall be unable to complete the arrangement plan or do any other thing hereunder within the initial moratorium period of 30 days he may apply to the court by [summons by way of summary procedure notice whereof to be given by advertisement] for an extension of the moratorium (court extension).

(2) The court may grant an extension of the moratorium period for a further period not exceeding 30 days (a first court extension).

(3) The provisional supervisor may apply to the court for further extensions (subsequent court extensions) subject to a maximum moratorium period of 6 months from the commencement of the provisional supervision. Any such subsequent court extensions shall be for such period whether exceeding 30 days or not as the court thinks fit.

(4) The court may grant a first court extension if satisfied :

(a) that the provisional supervisor is and has been acting with due diligence in his functions hereunder; and

(b) that the provisional supervisor will be likely to complete the arrangement plan within the period of the extension.

(5) The court may grant a subsequent extension if satisfied :

(a) that the provisional supervisor is and has been acting with due diligence in his functions hereunder;

(b) that the provisional supervisor will be likely to complete the arrangement plan and call the meeting of creditors to consider the plan within the period of the extension;

(c) the creditors as a whole would not be materially prejudiced by the extension. Any creditor opposing the extension shall have the burden of proving prejudice to himself.

(6) An application for a court extension must be filed before the expiry of the current period of the moratorium.

(7) Where an application for a court extension has been filed the current period of the moratorium shall continue until the application has been determined.

(8) Any creditor or other person affected by the moratorium may oppose any application to the court to an extension of the moratorium and if the court is satisfied that the extension would cause such creditor or other person significant financial hardship it may by order exempt such creditor or other person from the moratorium and any voluntary arrangement and from

the date of such order the provisions of section 9(9) (the moratorium) and the provisional supervision shall cease to apply to such creditor or other person.

(9) Where it appears to the provisional supervisor that he will be able to complete the formulation of an arrangement plan, but he will not be able to do so within 6 months from the commencement of the provisional supervision, he shall call a meeting of creditors to consider a further extension of the moratorium (creditors' extension). Such meeting must be called and held before the expiry of the period of 6 months from the commencement of the provisional supervision.

(10) For the purposes of such meeting the creditors shall form one class.

(11) 7 days' notice in writing of the meeting shall be given by the provisional supervisor to all creditors known to him still subject to the provisional supervision.

(12) The notice of meeting shall specify the time, date and place of the meeting and the purposes of the meeting, namely :

(a) to consider the statement of the provisional supervisor required pursuant to sub-section (13)(c) hereof and the views and opinions of the creditors;

(b) to decide the action to be taken by the meeting, namely whether or not the moratorium should be extended and if so for what period and on what terms.

(13) The notice of meeting shall inform the creditors to whom it is addressed that the following documents, namely :

(a) a report as specified in section 20(6)(a);

(b) a projected cash flow statement as specified in section 20(6)(b); and

(c) a statement, with reasons, why the provisional supervisor has been unable to complete the formulation of an arrangement plan within the moratorium period.

(14) The meeting of creditors shall resolve :

(a) to extend the moratorium for such period and on such terms as the meeting may decide: or

(b) not to extend the moratorium and that the company shall be wound up and to appoint a liquidator.

(15) Sub-sections (1) to (7) of section 21 shall apply to such meeting.

(16) The meeting of creditors may impose terms requiring the provisional supervisor to call a subsequent creditors' meeting to review the extension from time to time, but in any event where the moratorium is extended for 6 months or more the provisional supervisor shall call a meeting of creditors within one month of the expiration of 6 months from the date of the resolution to extend or the last meeting to review the extension, as appropriate.

(17) At a meeting to review the extension the notice of meeting shall specify that the purpose of the meeting is to review the extension and to resolve either to continue the extension, or to extend it or to terminate the extension and in the latter case that the company be wound up and to appoint a liquidator.

(18) At such meeting the creditors shall resolve :

(a) to continue the extension; or

(b) to terminate the extension and that the company should be wound up and to appoint a liquidator.

(19) Whenever it appears to the provisional supervisor that he will be able to complete the formulation of an arrangement plan, but he will not be able to do so within such period of extension as has been resolved upon by a meeting of creditors he shall call a meeting of creditors to consider a further extension of the moratorium and the provisions of sub-sections (9) to (18) shall apply mutatis mutandis.

Section 20 - Creditors' meeting to consider plan

(1) Where the provisional supervisor is satisfied that he will complete the formulation of an arrangement plan he shall call a meeting of creditors to consider the completed plan. So far as practical, arrangements for calling a meeting shall be put in hand in anticipation of the completion of the formulation of the arrangement plan.

(2) For the purposes of such meeting the creditors shall form one class.

(3) 7 days notice in writing shall be given of the meeting.

(4) Notice of meeting shall be given to all creditors, still subject to the provisional supervision, whose names and addresses appear in the company's statement of affairs made pursuant to section 15(2) and any other creditors, still subject to the provisional supervision, whose names and addresses are known to the provisional supervisor.

(5) The notice of meeting shall specify the time, date and place of the meeting and the purpose of the meeting, namely :

(a) to approve the arrangement plan (with or without modifications); or

(b) to adjourn the meeting for the purpose of the provisional supervisor submitting a modified plan to the adjourned meeting; or

(c) to reject the plan and to resolve that the company should be wound up and to appoint a liquidator.

(6) The notice of meeting shall inform the creditor to whom it is addressed that the following documents, namely :

(a) a report by the provisional supervisor concerning the business, property, affairs and financial circumstances of the company and any other matters in relation to the company as the provisional supervisor in his discretion considers necessary to enable the creditors to make an informed decision;

(b) a projected cash flow statement for the company;

(c) a statement, with reasons, as to the decision of the provisional supervisor that any (and which) of the purposes of a voluntary arrangement are capable of being achieved; and

(d) a draft of the arrangement plan,

are, or will be, available on application therefore to the provisional supervisor or are or will be, available for inspection at the provisional supervisor's office within normal office hours.

(7) The meeting of creditors shall resolve :

(a) to approve the arrangement plan (with or without modifications); or

(b) to adjourn the meeting for the purpose of the provisional supervisor submitting a modified plan to the adjourned meeting; or

(c) to reject the plan and that the company should be wound up and to appoint a liquidator.

(8) No modifications to the arrangement plan may be made unless the provisional supervisor consents to each such modification.

(9) The arrangement plan shall be deemed to be approved by the creditors when the resolution approving the arrangement plan (with or without modifications) is passed.

(10) If there is no quorum at the meeting of creditors it shall be deemed that the company should be wound up.

Section 21 - Proceedings and voting at creditors' meeting

(1) The persons entitled to attend a creditors' meeting are the provisional supervisor and all creditors of the company who have given due notice of their claims and are still subject to the provisional supervision.

(2) With every notice summoning a meeting there shall be sent out forms of proxy.

(3) The provisional supervisor shall be the chairman of the meeting, unless he nominates a partner or employee experienced in insolvency matters in his place.

(4) The chairman may hold a proxy or proxies and shall vote or otherwise as directed by the principal.

(5) Subject as follows, every creditor who is entitled to attend the creditors' meeting shall be entitled to vote at that meeting.

(6) Votes of unsecured creditors are calculated according to the amount of the creditor's debt at the commencement of provisional supervision (or where a provisional liquidator has made the proposal for voluntary arrangement as at the date of the presentation of the petition for winding up).

(7) Votes of secured creditors are calculated according to the amount of the creditor's debt as at the date referred to in sub-section (6).

(8) At a creditors' meeting, for any resolution to pass approving any proposal or modification there must be 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.

(9) The same applies in respect of any other resolution proposed at the meeting, but substituting one-half for two-thirds.

Section 22 - Implementation of creditors' decisions

(1) Where an arrangement plan has been approved by the creditors of the company, still subject to provisional supervision, pursuant to section 20 the provisional supervision shall cease (save for the purpose of concluding the relevant meeting and matters incidental thereto) and the terms of the

voluntary arrangement shall take effect and shall bind every person who was a creditor of the company and was entitled to vote at a meeting at which the arrangement plan was approved, and on the company and its members.

(2) The supervisor of the voluntary arrangement shall as soon as practicable :

(a) file certified copies of the voluntary arrangement at the Registry of the Supreme Court and at the Companies Registry; and

(b) cause to be advertised :

(i) in the next available issue of the Gazette and

(ii) in one local Chinese language newspaper and one local English language newspaper notice in the prescribed form that the company is under voluntary arrangement.

(3) If the provisional supervisor is not also the supervisor of the voluntary arrangement he shall do all things necessary to facilitate the transfer of office.

(4) Where the creditors resolve to terminate the provisional supervision pursuant to section 17(3)(a) the provisional supervision shall thereupon terminate (save for the purpose of concluding the relevant meeting and matters incidental thereto).

(5) Where the creditors have resolved or are deemed to have resolved pursuant to sections 17(12)(b) and (13), 19(4)(b) and (18)(c) or 20(7)(c) that the company should be wound up, the company shall be deemed to have been in a creditors' voluntary winding up as from the time of the appointment of the provisional supervisor and in default of any other person having been appointed liquidator of the company the provisional supervisor shall be deemed to have been appointed liquidator of the company for the purposes of such winding up and the provisions of this Ordinance applicable to a creditors' voluntary winding up shall apply hereto mutatis mutandis.

(6) Upon the termination of the provisional supervision or upon the creditors having resolved or being deemed to have resolved that the company should be wound up, the provisional supervisor shall file notices of cessation of provisional supervision the prescribed forms in both the Registry of the Supreme Court and the Companies Registry.

Section 23 - Effects of a voluntary arrangement

(1) While a voluntary arrangement is in effect in relation to a company :

(a) no creditor bound by the arrangement may commence or continue any winding up proceedings against the company;

(b) no resolution may be passed or made by the members or directors of the company for the winding up of the company;

(c) no receiver of the company may be appointed by a creditor bound by the arrangement or if already appointed no receiver may exercise any powers incidental to the office;

(d) no creditor bound by the arrangement may take any step to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession;

(e) no creditor bound by the arrangement may commence any proceedings, execution, distress or other legal process against the company.

(2) A voluntary arrangement shall cease to have effect in the events specified in the arrangement.

(3) Nothing herein contained shall prevent any creditor not bound by the arrangement from taking any action or other process available to that creditor.

(4) Where a company is subject to a voluntary arrangement, every invoice, order for goods or business letter issued by or on behalf of the company or the supervisor of the voluntary arrangement, being a document on or in which the name of the company appears, shall contain a statement that the company is subject to a voluntary arrangement.

Section 24 - Liability of provisional supervisor for new contracts

(1) The provisional supervisor shall be personally liable on any contract entered into by him in the performance of his functions, except in so far as the contract otherwise provides in writing, but he shall be entitled in respect of the liability to indemnity out of the assets of the company in accordance with section 28 and such liability shall be without prejudice to the rights of the provisional supervisor against the company or any other person.

(2) Nothing in sub-section (1) shall effect the liability of the company.

(3) The provisional supervisor shall not be deemed to have adopted any contract entered into by the company prior to the commencement of the provisional supervision.

(4) No contract entered into by the company prior to the commencement of the provisional supervision shall be determined or be

deemed to be determined by reason only that the company is in provisional supervision.

Section 25 - Provisional supervisor not otherwise liable for company's debts

The provisional supervisor of a company under provisional supervision shall not be liable for the debts or other liabilities of the company except under section 24.

Section 26 - Super priority

(1) Funds provided to the provisional supervisor or to the company by any creditor subject to the moratorium provisions herein during the provisional supervision period shall subject to section 28(2) have priority to the debts of all creditors whether preferential, secured, unsecured or otherwise, subject to the moratorium provisions for the purposes of any voluntary arrangement and for the purposes of any subsequent winding up of the company.

(2) The purpose of this provision is to provide working capital for the company during the provisional supervision period and the period of any voluntary arrangement. The priority shall apply only to funds provided for working capital for the company and such funds may not be used to discharge (in whole or in part) any liability of the company to the provider of the funds existing at the commencement of the provisional supervision period.

(3) For the purpose of this section the provision of funds includes (but is not limited to) advances of monies and the provision of credit by suppliers of goods and services or the suspension of liability to pay by the suppliers of goods and services or lessors of property used by the company.

Section 27 - Remuneration of the provisional supervisor

The provisional supervisor shall be entitled to such remuneration as shall be agreed between him and whoever nominates him and such remuneration shall be specified in prescribed consent to act form filed pursuant to section 6(2)(b).

Section 28 - Indemnity and lien of the provisional supervisor

(1) The provisional supervisor shall be entitled to be indemnified out of the property of the company for all debts for which he is liable as provisional supervisor and for his remuneration and all reasonable expenses of the provisional supervision.

(2) The indemnity of a provisional supervisor shall have priority to all other claims (whether secured or unsecured) against the company and the super-priority granted by section 26.

(3) The indemnity of a provisional supervisor shall be secured by way of lien over the property of the company, which lien shall have priority over all other securities over the property of the company.

Section 29 - Vacation of office

(1) A provisional supervisor may resign with leave of the court upon application therefore by him [by way of summary procedure].

(2) Such leave shall only be granted where the court is satisfied :

(a) that the circumstances are exceptional;

(b) where for the provisional supervisor to continue in office would cause severe personal hardship to him; and

(c) a replacement has been nominated and consented to act.

(3) Before applying to the court for leave to resign the provisional supervisor shall give notice of his intended application to whomsoever nominated him (or, in the case of a provisional liquidator acting as provisional supervisor, to the court).

(4) On receipt of such notice the nominator (or, as appropriate, the court) shall proceed to nominate a replacement.

(5) Where a provisional supervisor :

(a) dies; or

(b) becomes mentally incapable; or

(c) ceases to be a person who may be a provisional supervisor pursuant to section 5,

the nominator (or, as appropriate, the court) shall proceed to nominate a replacement.

(6) The replacement provisional supervisor shall become provisional supervisor and his appointment shall take effect :

(a) where leave is given under sub-section (1) upon the filing of the consents to act in the prescribed form at the Registry of the

Supreme Court and the Companies Registry (whichever is the last);

(b) in any other case upon the filing of the consents to act in the prescribed form at the Registry of the Supreme Court and the Companies Registry (whichever is the last).

(7) As soon as practicable after the appointment of the replacement provisional supervisor shall take effect he shall cause to be advertised :

(a) in the next available issue of the Gazette; and

(b) in one local Chinese language newspaper and one local English language newspaper notice in the prescribed form of his appointment.

(8) Upon the appointment of the replacement provisional supervisor taking effect, the person who has ceased to be provisional supervisor shall, with effect from that time, be released from office and from all future liability in respect of the provisional supervision.

(9) It is an offence for a provisional supervisor to continue in office when he has ceased to be a person who may be a provisional supervisor pursuant to section 6.

(10) A provisional supervisor shall carry out his functions, duties and powers under this Part in good faith and with due diligence.

(11) If, following a provisional supervision which did not result in a voluntary arrangement the company is wound up and it appears to the liquidator in such a winding up that the provisional supervisor was in breach of sub-section (10) :

(a) The liquidator shall make a report to this effect and where the liquidator is not the Official Receiver forward such report to the Official Receiver; and

(b) The Official Receiver may apply to the court for an order that the provisional supervisor be disqualified from acting as such for such period as the court thinks fit and may forward the report to the provisional supervisor's professional body.

(12) In the event of the company going into liquidation before any voluntary arrangement has been approved the provisional supervisor (unless he shall be liquidator) shall pass over all documents etc. and disclose all information obtained by him in the provisional supervision to the liquidator.

Section 30 - Supervisors of voluntary arrangements

(1) The following may act as supervisor of a voluntary arrangement :

(a) a registered insolvency practitioner;

[or until such regime is established

(a) a professional accountant;

(b) a solicitor of the Supreme Court of Hong Kong; who has a current practising certificate;

(c) a provisional liquidator who acted as provisional supervisor.]

(2) A supervisor of a voluntary arrangement shall :

(a) perform such duties and functions and have such powers as may be specified in the arrangement;

(b) ascertain on behalf of the creditors that the arrangement is being adhered to and implemented by the company in accordance with its terms;

(c) supervise the arrangement having regard to the interests of the creditors of the company, the company itself and the shareholders of the company.

(3) A supervisor of a voluntary arrangement :

(a) may require any officer of the company or any employee of the company who in the opinion of the supervisor is capable of giving the information required to provide such information about the business, property, affairs or financial circumstances of the company as the supervisor may reasonably request;

(b) shall have access to the premises and all books and records of the company upon reasonable notice;

(c) may examine any officer or employee of the company as to the affairs of the company.

(4) Any officer or employee of the company who fails to comply with any request from the supervisor under his powers in sub-section (3) shall be guilty of an offence.[4]

(5) A supervisor of a voluntary arrangement may apply to the court for directions in relation to any particular matter arising in connection with his functions, duties and powers under the arrangement.

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[4] With the same penalties as proposed under section 15(6).

(6) If any party to a voluntary arrangement is dissatisfied by any act, omission or decision of the supervisor, he may apply to the court; and on application the court may-

(a) confirm, reverse or modify any act or decision of the supervisor,

(b) give him directions,

(c) remove him from office, or

(d) make such other order as it sees fit.

Section 31 - Vacation of office etc of supervisor

(1) The voluntary arrangement shall make provision for the resignation and removal of the supervisor and for his replacement in the event of such, or of his death, mental incapacity or ineligibility to act as supervisor.

(2) Wherever :

(a) it is expedient to appoint a person to carry out the functions of a supervisor; and

(b) it is inexpedient, difficult or impracticable for an appointment to be made without the assistance of the court,

the court may, upon the application [in a summary manner] of the company, the directors of the company or any creditor of the company make an order appointing a supervisor of a voluntary arrangement, either in substitution for the existing supervisor or to fill a vacancy.

Section 32 - Notifications

(1) Within 14 days of a new supervisor (appointed under the voluntary arrangement as by court order under section 31) taking up office he shall file a notice of change of supervisor in the prescribed form at the Registry of the Supreme Court and the Companies Registry.

(2) Where the voluntary arrangement ceases to have effect, the last supervisor of the arrangement shall, within 14 days after the voluntary arrangement ceases to have effect send notice in the prescribed form that the voluntary arrangement has ceased to have effect to the Registry of the Supreme Court and the Companies Registry.

Section 33 - Crown bound

The provision of this Part and in particular section 9(9) (the moratorium

provision) shall bind the Crown as creditor.

PART IV C

INSOLVENT TRADING

Section 34 - Responsible person's duty to prevent insolvent trading

(1) This section applies where -

(a) the person was a responsible person which for the purposes of this section means a person who is or has been a director or manager or other person involved in the management of the insolvent company at the time when any debt or debts were incurred and the company was insolvent at that time or there was no reasonable prospect of avoiding becoming insolvent, and

(b) at that time the person

(i) knew that the company was insolvent,

(ii) ought to have known that the company was insolvent or would so become, or

(iii) had reasonable grounds for suspecting that the company was insolvent or would become insolvent, and

failed to prevent the company from incurring such debt or debts.

(2) For the purposes of this section, a company is insolvent if in the course of its business its assets are insufficient to discharge its debts and other liabilities in full as they fall due.

(3) For the purposes of this section, suspicion means that

(a) the person should be aware at that time that there are such grounds for so suspecting; or

(b) a reasonable person in a like position in a company in the company's circumstances would be so aware.

(4) Where, on an application for an order against a person in relation to a contravention of subsection (1), the court is satisfied that:

(a) the person committed the contravention in relation to the

incurring of a debt by the company; and

(b) the debt is wholly or partially unsecured; and

(c) the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency;

the court may order the person to pay to the company compensation equal to the amount of that loss or damage or such other sum as the court thinks fit.

(5) An order to pay compensation that a court makes under subsection (4) may be enforced as if it were a judgment of the court.

(6) Subsection (4):

(a) has effect in addition to, and not in derogation of, any rule of law about the duty or liability of a person because of the person's office or employment in relation to a company; and

(b) does not prevent proceedings from being instituted in respect to a breach of such a duty or in respect of such a liability.

Section 35 - Presumptions

(1) Subsections (2) to (6) inclusive, have effect for the purposes of an application to the court for trading while insolvent in relation to a company.

(2) If :

(a) the company is being wound up;

(b) it is proved, or because of subsection (3) it must be presumed, that the company was insolvent at a particular time during the 12 months ending on the relation-back day [the date of commencement of the winding up];

it must be presumed that the company was insolvent throughout the period beginning at that time and ending on that day.

(3) Subject to subsections (4) and (5), if it is proved that the company :

(a) has contravened section 121 [of the Companies Ordinance] by failing to keep proper accounting records that correctly record and explain;

(i) its transactions (including its actions as trustee) during a particular period ("the relevant period"); and

(ii) its financial position during the relevant period;

or by failing to keep such accounting records in the manner required by section 121(2); or

(b) has contravened section 121(3A) by failing to retain such accounting records for the period required by that subsection;

it must be presumed that the company was insolvent throughout the relevant period.

(4) Subsection (3) (a) does not apply in relation to a contravention of section 121(1) that is only minor or technical.

(5) Subsection (3) does not have effect, in so far as it would prejudice a right or interest of a person for the company to be presumed insolvent because of a contravention of subsection 121(2) if it is proved that:

(a) the contravention was due solely to someone destroying concealing or removing accounting records of the company;

(b) none of those accounting records were destroyed concealed or removed by the first-mentioned person; and

(c) the person was not in any way, by act or omission, directly or indirectly, knowingly or recklessly, concerned in, or party to, destroying, concealing or removing any of those accounting records.

(6) A presumption for which this section provides operates except in so far as the contrary is proved for the purposes of the proceedings concerned.

Section 36 - Defences

(1) The court shall not make an order under section 34(4) with respect to any person if it is satisfied that after the condition specified in section 34(1)(b) was first satisfied in relation to him that person, acting bona fide, took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

(2) For the purposes of section 34(1)(b), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known and ascertained, or reached or taken, by a reasonably diligent person having both -

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company,

(b) the general knowledge, skill and experience that that director has.

(3) The reference in subsection (2) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(4) In determining whether a defence under subsection (1) has been proved, the matters to which regard is to be had include, but are not limited to:

(a) any action the person took with a view to appointing a provisional supervisor of the company; and

(b) when the action was taken; and

(c) the results of that action.

Section 37 - Court may make order imposing liability

(1) Where :

(a) a company is being wound up; and

(b) at or after the commencement of this Part and within 4 years before the relation-back day, a person contravened Part IV A of the Companies Ordinance [the Disqualification of Directors provisions];

the court may, on the application of the company's liquidator, order that the person is personally liable for so much of the company's debts and liabilities as does not exceed an amount specified in the order.

Section 38 - Application of amount paid as compensation

Where the court is satisfied that, at the time when a company incurred a debt, the person who incurred the loss or damage knew that the company was insolvent at that time or was likely to become insolvent, the court may order that the compensation or amount paid to the company is not available to pay that debt unless all the company's other debts (other than debts to which orders under this section relate) have been paid in full.