THE LAW REFORM COMMISSION OF HONG KONG

REPORT

CORPORATE RESCUE AND INSOLVENT TRADING

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OCTOBER 1996

The Law Reform Commission was established by His Excellency the Governor in Council in January 1980. The Commission considers such reforms of the laws of Hong Kong as may be referred to it by the Attorney General or the Chief Justice.

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OF HONG KONG

REPORT ON

CORPORATE RESCUE AND INSOLVENT TRADING

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Introduction

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 US 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. A sub-committee was appointed by the Attorney General to consider the reference and report to the Commission. The sub-committee on insolvency 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 Company Ltd
Mr S. K. Cheung (since 7.8.1995)	Senior Executive, Corporate & Institutional Banking, Hongkong and Shanghai Banking Corporation Ltd
Mr Nicholas Etches	Accountant, KPMG Peat Marwick
Mr Stefan Gannon JP	General Counsel to the Hong Kong Monetary Authority
Mr David Hague	Accountant, Price Waterhouse
Mr Robin Hearder JP	The Official Receiver
Mr Nic Johnston (since 7.8.1995)	Solicitor, Freshfields
Ms Barbara Martin (until 21.8.1995)	Solicitor, Carey & Lui
Mr Michael Page (until 30.3.1994)	Senior Manager, Hong Kong & Shanghai Banking Corporation Ltd
Mr David Tam Wai-hung (from 25.4.1994 to 19.7.1995)	Senior Executive, Corporate and Institutional Banking, Hong Kong & Shanghai Banking Corporation Ltd
Mr Winston Poon QC	Barrister
Mr Ian Robinson	Accountant, formerly of Ernst & Young, now a director of Robinson Management Limited
Mr Jeremy Glen	Senior Crown Counsel (Secretary)

4. The terms of reference provide that the Commission 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 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. The Commission's Report on Bankruptcy was published in May 1995.

5. Following completion of its report to the Commission on bankruptcy the sub-committee considered that, as provided for under paragraph 2(b) of the terms of reference, it would be appropriate to make a second interim report to the Commission on the issue of making provision for a procedure to facilitate the rescue of ailing companies. The sub-committee's report to the Commission on a procedure for corporate rescue and for a provision which could impose liability on directors and senior management of a company for insolvent trading has formed the basis of this report.

The need for an interim report on corporate rescue and insolvent trading

6. The sub-committee on insolvency considered that provisions of the Companies Ordinance relating to arrangements and reconstructions were inadequate as they were not capable of providing the legislative and procedural support required to propose and formulate a voluntary arrangement. The sub-committee considered that Hong Kong needed a comprehensive system to enable and encourage the reorganisation of companies in situations where liquidation was not the appropriate solution. The sub-committee noted that reorganisation or rescue provisions had been introduced in a number of jurisdictions in recent years and have generally been well received.

Submissions on the Consultation Paper on Corporate Rescue and Insolvent Trading

7. A Consultative Document on Corporate Rescue and Insolvent Trading setting out the sub-committee's proposals was published by the sub-committee on insolvency in May 1995. Altogether there were 30 substantive submissions on the proposals and the general response was supportive. Points made in the submissions were considered by the sub-committee and, where appropriate, were referred to its report to the Commission. Some of the arguments for amendment of the proposals presented in the Consultation Paper were accepted by the sub-committee and these amendments are acknowledged in this report.

8. The Commission considered the sub-committee's report in detail and this report substantially supports the sub-committee's proposals. Where the Commission has departed from the sub-committee's proposals the reasons are given and the sub-committee's proposals are recorded.

Confidentiality

9. This report is in line with the Commission's recent policy of naming those who make submissions unless confidentiality is requested, though only where it is considered appropriate. None of those who made

submissions requested confidentiality. A list of those who made substantive submissions is annexed (Annexure I). The Commission would like to express its gratitude to all those who responded to the Consultation Paper.

Model Bill

10. The sub-committee on insolvency prepared a model Bill to assist them in their deliberations on corporate rescue and insolvent trading. The sub-committee found the model Bill useful in drawing the provisions together and ironing out contradictions. The model Bill was published in the Consultation Paper on Corporate Rescue and Insolvent Trading. While the model Bill was intended to assist those considering the Consultation Paper it was never intended that it should be adopted as draft legislation. In the circumstances the Commission prefers to publish this report without a model Bill attached.

11. While many aspects of procedure are addressed in the report, not all of the relevant supporting rules are referred to when recommendations are based on existing legislation in other jurisdictions. It is the general intention, however, that the relevant supporting rules would be adopted in respect of each proposal that draws on existing provisions.

Abbreviations

12. For the sake of brevity, references to "he" mean "he or she" unless the context implies otherwise. Abbreviated forms of the following reports and legislation have been used:

"The Cork Report" : The Report of the United Kingdom Committee on Insolvency Law and Practice under the Chairmanship of Sir Kenneth Cork.[1]

"The Harmer Report" : General Insolvency Inquiry: a Report of the Law Reform Commission of Australia under the Chairmanship of Mr Ron Harmer.[2]

"The Insolvency Act" : This refers to the United Kingdom Insolvency Act 1986.

"The Insolvency Rules" : This refers to the United Kingdom Insolvency Rules 1986.

Acknowledgements

13. In the course of its considerations the sub-committee on insolvency had the benefit of meeting, on separate occasions, with Colin Bird,

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[1] 1982. Cmnd 8558.

[2] Report No. 45, September 1988.

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.

14. Finally, we extend our thanks to the sub-committee on insolvency without whose considerable efforts this report would not have been possible.

Report in English and Chinese

15. This report is available in both Chinese and English.

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 a non-statutory arrangement or by means of the arrangement and reconstruction provisions under section 166 of the Companies Ordinance, 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 to prevent 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 recommendations. 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. Indeed, proposals for a new company voluntary arrangement procedure in the United Kingdom would be in addition to the two existing procedures.[1]

1.4 The sub-committee on insolvency's Consultation Paper on Corporate Rescue and Insolvent Trading proposed that it was worth considering amending section 166 to provide for a moratorium where a company was insolvent and added that section 166 might still be used in circumstances where the proposed procedure was terminated without a voluntary arrangement having been achieved, though this was unlikely to happen as there is extensive provision made for the procedure to be extended at the behest of creditors.[2] The sub-committee reconsidered this statement following a submission which pointed out that if an attempt to secure a voluntary arrangement through a provisional supervision was

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1 See paragraph 1.14.
2 See paragraph 15.14.

unsuccessful, a further moratorium provision would be unnecessary because at this point the only viable solution would be liquidation and there should be no necessity for there to be any further attempt to rescue the company.[3] The sub-committee agreed with the submission, stating that it was never its intention that moratoria under provisional supervision and section 166 should be cumulative or consecutive. The sub-committee also reconsidered the proposal that section 166 might be linked to a moratorium and recommended no such amendment, on the basis that section 166, combined with a moratorium, would create a debtor in possession type situation akin to Chapter 11, particularly in the case of a company which had not been wound up.[4] In essence, the sub-committee saw no objection to a proposal under section 166 flowing into provisional supervision but did not countenance it happening the other way round.[5] We agree with the sub-committee's view.

1.5 It was submitted that section 166 may be used both before and after winding-up and that neither the presentation of a petition nor an order made upon it would, as a matter of law, finally end the possibility of a scheme. Given the procedural requirements for advertising, and the practical considerations for fixing dates, there would inevitably be a time lapse between presentation of the petition and a hearing on the merits, which, although not a true moratorium, is an effective period of time in which proposals can be finalised. In addition, once a petition is presented, the court has power to grant a stay of proceedings or execution where a scheme is being prepared. The submission concluded that if lack of a moratorium was considered to be a major defect, consideration could be given to extending section 181 of the Companies Ordinance to pre-presentation situations.[6]

1.6 The point is mentioned only in passing as it does not have a direct bearing on the recommendations for provisional supervision. We will consider the suggestion further in our final report on the winding-up provisions of the Companies Ordinance. It does, however, prompt us to address suggestions that the step by step procedure we recommend cannot be cheaper, quicker, simpler and more effective when compared to the seemingly simple alternative under section 166.

1.7 We are convinced that provisional supervision would be better than the existing procedures for the following reasons:

- First, provisional supervision would provide a solid basis on which to calculate the costs and time involved in putting a proposal to creditors. Section 166 is an open-ended procedure, which provides no assistance in planning the time it would take and the cost of putting a proposal to creditors.

- Second, provisional supervision would provide a flexible framework which would allow the provisional supervisor to take on his task in

3 Submission of the Hong Kong Association of Banks.
4 Note the views expressed against a debtor in possession procedure at paragraph 1.11.
5 Note paragraph 4.14.
6 Submission of the Hong Kong Bar Association.

relative peace in that he would be guaranteed court protection from the outset. Section 166 provides no court protection.

- Third, provisional supervision would limit the costs of court appearances as the provisional supervisor would only have to approach the court, apart from exceptional matters, after 30 days, and after that only when an extension of provisional supervision is sought or the company is deemed to be wound up as a creditors' voluntary winding up. Under section 166, the number of court applications and hearings have no limit.

- Fourth, provisional supervision sets out the role of the provisional supervisor, gives the provisional supervisor the power of management together with rights duties and liabilities, prevents rogue creditors from threatening proceedings as a form of leverage, permits super priority borrowing, allows creditors to vote on the proposal when formulated and provides a smooth transition into a company voluntary arrangement or winding-up as the case may be. Section 166 provides none of these things which, we consider, is a discouragement to companies ever starting the process in the first place.

- Fifth, provisional supervision would provide certainty. Even disaffected creditors could be sure that after usually not more than six months, they would have their say on a proposal. They would know this from the outset. Section 166 provides no certainty. A member of the sub-committee on insolvency spoke of his experience when, as a receiver of a company some years ago, he carried out a voluntary arrangement under section 166. He estimated that he could have completed the scheme in one month rather than the five months it took, he would have had one creditor's meeting instead of the three it needed, on top of which there were many other procedures and pressures that had to be dealt with which could have been limited if provisional supervision had been available. Finally, the company concerned was in receivership for two years before the proposal for a company voluntary arrangement was put to creditors; a period of uncertainly that could have been avoided under provisional supervision.

Other jurisdictions

1.8 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, 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" [7] and the experience of the company voluntary arrangement and administration procedures under the Insolvency Act 1986 have been drawn on.

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

1.9 The "Harmer Report"[8], the result of the Australian Law Reform Commission's General Insolvency Inquiry under the Chairmanship of Mr Ron Harmer was considered together with the recent Australian provisions on administration of a company's affairs with a view to executing a deed of company arrangement.[9] The Canadian provisions for a general scheme for proposals were also considered.[10] 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.

1.10 Chapter 11 of the United States Bankruptcy Code was looked at 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 did 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 reflected this in providing for an outside party, the provisional supervisor, to take effective control of the company during the proposal period, to be known as the provisional supervision period.

1.11 It is worth noting that several submissions expressed outright hostility towards the Chapter 11 concept of debtor in possession, perhaps best summed up by a submission which stated that it was a concern that provisional supervision should not become a simple way for a company to avoid or delay its obligations to creditors, adding that in this respect, the proposals seemed reasonably fair but expressing concern that representations from other parties might influence us to move towards the US model of Chapter 11.[11]

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.[12]

1.13 The provisions on judicial management in Singapore, which follows the Insolvency Act 1986 to a significant extent were considered together with the provisions on examinership in Ireland.[13]

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

8 Report No. 45, September 1988.
9 Corporate Law Reform Act 1992.
10 Bankruptcy and Insolvency Act 1992, Part III.
11 Submission of the Hong Kong Federation of Insurers.
12 Note the recent Australian experience with their new procedure at paragraph 2.1.
13 The Companies (Amendment) Act 1990.

administration procedures.[14] In the United States, Chapter 11 is being reconsidered and the comparatively recent Irish procedure is also being reconsidered.

Benefits of provisional supervision

1.15 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 needed a formal procedure for restructuring as opposed to the existing situation which, it may be argued, allows businesses to decline and die and encourages the development and growth of new businesses.

1.16 This argument was taken up by the one submission which expressed serious reservations about the proposals.[15] The submission questioned the need for "Government-mandated" intervention in corporate failure at all. No other submission took this view. The balance of opinion was strongly supportive of the introduction of measures such as those proposed in the Consultation Paper.

1.17 The process of decline and growth would continue in any event. We are in no doubt 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 share holdings 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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[14] The Insolvency Act 1986: Company Voluntary Arrangements and Administration Orders, A consultative Document. October 1993. This was followed in April 1995 by a Consultative Document with Revised Proposals for a new Company Voluntary Arrangement Procedure. See paragraph 1.3.

[15] Submission of the Hong Kong Democratic Foundation.

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 would otherwise be unlikely to get anything from a winding up.[16]

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. 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%. In 1993/94 the average time was 2.85 years to pay an average dividend of 63.37% and in 1994/95 the average was 2.88 years to pay an average dividend of 59.28%.

1.21 We are mindful that provisional supervision would have far reaching consequences for employees in terms of entitlements to severance payments. These concerns are addressed in detail elsewhere in the Report.[17]

1.22 We consider that employees would be placed in a better condition under provisional supervision than under liquidation. The best chance of a solution that would achieve the most benefit for all parties, whether employer, employee or creditor would come under a scheme of voluntary arrangement fostered by provisional supervision. Provided all parties approached provisional supervision in a reasonable manner the provision would be constructive rather than divisive.

Unsecured creditors

1.23 Unsecured creditors are often considered to have a raw deal in a liquidation. By the time preferential creditors have been paid and secured creditors have taken their entitlement out of a company, unsecured creditors

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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. The figure for return of capital to shareholders in 1994/95 was $7,937,000, or about 14%. Source: Official Receiver's Office, Annual Departmental Report 1994 - 95, annex 14, page 3.

[17] See paragraphs 5.40 to 5.50.

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. 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%; in 1993/94 the average time was 4.51 years to pay a dividend of 32.82%; and in 1994/95 the average time was 4.62 years to pay an average dividend of 26.98%.

Secured creditors

1.24 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 nature of floating charges in particular, 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 under-secured. In such a situation, the secured creditors might conclude that a voluntary arrangement was an attractive proposition.

1.25 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.

1.26 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.[18]

1.27 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, within two weeks of going into administration. 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

1.28 The procedure we contemplate, while borrowing from other procedures, has its own characteristics and is quite distinct. To distinguish it further we settled on provisional supervision, as the procedure revolves around the person who is 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.

1.29 When work started on this report there were no preconceived ideas as to the system that would be adopted. 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. This reasoning is developed in the following chapters, which detail the procedure.

1.30 The ideal procedure would be cheap, quick, simple and effective. To be effective, however, a proper procedure comes with 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. The four criteria above were, however, given a high priority at all stages of the procedure and every effort has been made to reduce the chances of a long, involved and expensive process.

1.31 Attention has been given to keeping the procedure within strict time limits, as undue delay acts against the chances of success of a reorganisation, by imposing an initial stay of 30 days which may be extended

[18] 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.

by application to the court. In this, the new Australian and Canadian provisions were drawn on. Although initially it was intended that the moratorium should only last for a maximum of six months in the end it had to be accepted, reluctantly, that a strict six 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 recommendations for the provisional supervisor to put his proposal to creditors before the expiration of six months.

1.32 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 the filing requirements and in a straightforward case, a workout could be achieved within 30 days without going to the court.

1.33 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 would 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.

1.34 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 and our recommendations introduce more stringent recommendations on who may be the provisional supervisor and how their fees would be regulated than those proposed by the sub-committee on insolvency.[19] The cheaper that a procedure is to initiate and run, the more viable a proposition it becomes to a greater number of companies in difficulties.

1.35 One of the best ways of keeping costs down is to limit the involvement of the courts. There is therefore a corresponding need to have practitioners of the highest quality to supervise a proposal. High quality professionals are not cheap but, under the 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 combined with an extensive moratorium, should avoid the sort the problems associated with, for example, Chapter 11 proceedings in the United States.

1.36 We consider that only one procedure, in addition to the provisions under section 166, needs to be introduced, initially at least. We

[19] See paragraphs 9.18 and 9.19.

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 would be regrettable but may be unavoidable if a system capable of withstanding the pressures of a major reorganisation is to be introduced.[20]

1.37 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.

1.38 Provisional supervision would 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.

1.39 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

1.40 The issue of co-operation in international insolvencies and restructuring needs to be considered in the overall context of insolvency law. For that reason, we have not made any recommendations 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.

1.41 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 304 of the United States Bankruptcy Code also permits co-operation with foreign courts by allowing a case ancillary to a foreign proceeding to be

[20] But see the comment on the experience in Australia in paragraph 2.1.

filed in the United States courts by a foreign representative. The Australian Corporations Law also makes provision for reciprocity with other jurisdictions.

1.42 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.

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

Environment

1.44 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.

1.45 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

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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.

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 which 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 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."*

1.46 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]

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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.

1.47 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]

1.48 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.

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

1.50 The second situation concerns environmental damage that occurs after the provisional supervisor's appointment. We recommend 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.

1.51 The third situation is covered by our second proposal but for certainty we recommend 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.

1.52 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.

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[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.

Insolvent trading

1.53 In the context of the directors and senior management acting on insolvency earlier rather than later, we recommend in Chapter 19 that directors and senior management, who would be known under the collective title of "responsible persons", could be made personally liable for the debts of a company which traded while insolvent. The respective duties of directors and senior management as regards trading while insolvent would be defined. The hope is that the introduction of an insolvent trading provision would assist in encouraging directors and senior management to consider going into provisional supervision early as the prospect of personal liability would give many directors and senior management pause for thought before they allowed a company to proceed into an insolvent trading position.

Chapter 2

Companies to whom provisional supervision would apply

2.1 There were two issues involved in deciding which companies provisional supervision should apply to. The first issue was that we did not expect nor did we intend that supervision should become the panacea for all ailing corporations. We thought, from the experience of other jurisdictions, that provisional supervision would only be viable for relatively small numbers of companies. We have recently seen figures from Australia, however, that offer encouraging evidence of the enthusiasm with which the new voluntary administrations procedure under the Corporate Law Reform Act 1992 has been adopted in that country. In 1993 there were 349 voluntary administrations against 2,253 liquidations. In 1994, there were 1,326 voluntary administration against 1,299 liquidations and in the year to the end of August 1995 there were 2,258 voluntary administrations against 1,395 liquidations.[1] It is difficult without greater analysis to know what can be drawn from these figures but they tend to lend credence to the argument that corporate rescue procedures have a place in the insolvency regime. It may be noted that Australia did not have a comprehensive corporate rescue procedure before the 1992 Act. The alternatives available were schemes of arrangements and official management. The figures for schemes of arrangement between 1991 and 1995 were consistent at between 22 and 40 annually while official management cases went from 13 in 1991 and nine in 1992 to none in 1994 and 1995.

2.2 What may have happened was that there was a crying need for a viable rescue procedure in Australian, a country which had gone through a traumatic recession over the last several years. Perhaps Australia was ripe for corporate rescue. We do not anticipate that Hong Kong would embrace the procedure with such alacrity but we are encouraged by the Australian experience.

2.3 The procedure aims to 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

[1] The figure for 1995 is based on actual figures to 31 August 1995 calculated for the full year from a monthly rate. Source: "An Analysis of the current state of the Insolvency Profession in Australia", a paper by Martin Jones of Ferrier Hodgson to the INSOL Regional Conference in Hong Kong, November 1995.

benefit businesses in Hong Kong and, consequently, benefit Hong Kong as a whole.

2.4 The second issue is that, while provisional supervision should be available to as many companies as possible, there are certain industries which may be exempted from the recommendations for the reasons stated later in this chapter.

Companies to whom the procedure would apply

2.5 The Consultation Paper proposed that 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. Submissions were received, however, from organisations involved in those industries which led to an industry by industry approach being taken. We endorse this approach.

2.6 For the avoidance of doubt, provisional supervision would apply to both listed and unlisted companies.

2.7 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 May, 1995 there were 462,489 locally incorporated companies on the companies register. Of these 456,144 were private companies and 6,345 were public companies, 510 were companies limited by shares and 5,835 were companies limited by guarantee. A total of 4,127 oversea companies were registered under Part XI, representing a 10% increase over the corresponding figure of 3,778 in July 1994. In April 1994 the Hong Kong Stock Exchange had 275 Part XI companies listed and 201 locally incorporated public companies.[2]

2.8 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 this Ordinance."*

2.9 The inclusion of oversea 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

[2] Source: Registrar of Companies.

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, the procedure should be available to them whether they choose to incorporate under Part I or to register under Part XI.

2.10 It would be inadvisable for a provisional supervisor to be appointed over an oversea company which had most of its assets and share holding 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.

2.11 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

2.12 The sub-committee on insolvency's Consultation Paper proposed that the procedure should not apply to industries that were already regulated by statute and which had provision for the relevant authority to assume control of the business or oblige a business to act in a certain manner. The industries identified were (i) banking, (ii) insurance and (iii) securities and futures. It was noted that the regulatory powers of each industry differed substantially, according to their needs and that the Securities and Futures Commission Ordinance and the Securities Ordinance did not provide a detailed insolvency regime, whereas the Banking Ordinance did. While the Consultation Paper did not propose that provisional supervision should be imposed on these industries it suggested that the regulatory bodies consider whether to apply a remedial procedure through their own legislation. We endorse this approach.

Banking

2.13 We recommend that provisional supervision should not apply to authorised institutions, that is, banks and deposit taking companies regulated under the Banking Ordinance.[3] The banking sector is unique in the context of Hong Kong's economy as the banks, through their lending, are involved in every area of trade and industry. The Hong Kong Monetary Authority, whose function is to promote the general stability and effective working of the

3 Banking Ordinance, (Cap 155).

banking system, tightly controls banking operations and already had extensive powers of control over authorised institutions. These powers were recently enhanced by the Banking (Amendment) Ordinance 1995.[4]

2.14 The powers of the Monetary Authority are so extensive that provisional supervision would not only duplicate the provisions already in place, but the availability of provisional supervision to the directors of authorised institutions could create problems, as a provisional supervisor appointed by the directors could be in conflict with a manager appointed by the Monetary Authority under its powers of control of authorised institutions in Part X of the Banking Ordinance. Such a situation cannot even be contemplated.

2.15 Under Part X, the Monetary Authority has power, in specified circumstances, to appoint a manager over an authorised institution.[5] The Part is specifically designed with authorised institutions in mind and we consider that the more general nature of provisional supervision would not improve on the provisions in place.

Insurance

2.16 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.[6] It is 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.[7]

2.17 Submissions were received from the Office of the Commissioner of Insurance ("the Insurance Authority") and from the Hong Kong Federation of Insurers ("the Federation"). The Insurance Authority, noting that the Insurance Companies Ordinance has specific provisions for the control of an insurer prior to its winding-up, supported the proposal that the insurance industry be exempted from the provisional supervision, adding that it would, in due course, consider the implications of the proposals and incorporate them into the Insurance Companies Ordinance where considered appropriate.

2.18 The Federation also noted the wide powers of intervention of the Insurance Authority and expressed the hope that the powers would be good enough to enable a successful rescue to be effected in the vast majority

4 Ordinance No. 49 of 1995.
5 For the powers of a manager see section 53C and the Ninth Schedule of the Banking Ordinance.
6 Insurance Companies Ordinance (Cap 41), section 41.
7 Insurance Companies Ordinance, sections 45 and 46.

of cases of an insurance company getting into difficulty. The Federation, however, presented a scenario of a well regarded insurance company finding itself technically insolvent. Under the current regime, the company would be able to continue to accept renewal premiums on its long term policies but it would be unable to effect any new life or general insurance policies with the consequence that its distribution network would disappear very quickly, destroying the goodwill of the company and making rescue more difficult. Under those circumstances, the Federation suggested that it might be preferable for the company to be allowed to continue writing new business in order to retain the value of its distribution network. Such a decision would be made by the Insurance Authority given that it already has powers of intervention. As a consequence the Federation submitted that the proposed exemption for insurance companies should be deferred until such time as the Insurance Authority chooses to incorporate a similar provision within the Insurance Companies Ordinance.

2.19 We do not see the Insurance Authority and the Federation as being in disagreement over the issue; they simply arrive at the same conclusion by different routes. We note that both bodies want to see provisional supervision applied to the insurance industry and therefore recommend that provisional supervision should apply to insurance companies. We recognise, however, that policy issues need to be addressed by the Insurance Authority and consider that it would be best left to the Commissioner to decide how provisional supervision would be incorporated into the insurance regime.

Securities and Futures

2.20 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 Commission 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 Commission may petition for a receiving order against a registered person if the registered person has committed an act of bankruptcy.[8] The Commission 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.[9]

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8 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.

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

2.21 Under the Securities Ordinance[10] 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.

2.22 The Securities and Futures Commission submitted that the powers referred to above enable it to act against a regulated person to protect assets or to restrict its business while investigatory or enforcement action is taken, whereas provisional supervision provides a company in financial difficulties with a breathing space to reorganise its affairs voluntarily. The Securities and Futures Commission considers that it is desirable for registered entities to be able to take advantage of provisional supervision in appropriate circumstances, as not only will investors be better off if the entity survives, but considerable public expense could be saved if such arrangements can be reached privately. We accordingly recommend that provisional supervision should apply to the Securities and Futures industry.

Leveraged Foreign Exchange trading

2.23 We note that the Securities and Futures Commission also advised that the list of industries regulated by the Commission should include the leveraged foreign exchange trading industry which is regulated under the Leveraged Foreign Exchange Trading Ordinance.[11]

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10 Securities Ordinance (Cap 333), section 144.

11 Cap 451. The powers of intervention, which are found at sections 49 to 55, and 59 to 60 of the Ordinance are similar to those provided under the Securities and Futures Commission Ordinance. Note also section 13 which allows the High Court to make orders in respect of leveraged foreign exchange trading in certain circumstances.

Chapter 3

Purposes of provisional supervision

3.1 This chapter sets out a general statement of the purposes of provisional supervision.

3.2 The purposes are simply guidelines and it is not intended 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 able to initiate the procedure would be in a position to appreciate a 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 would be, 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.

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,

(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.

3.7 The provisional supervision procedure would aim to give a company the best possible chance of emerging from it into supervision, and subsequently from supervision, in the best state that could be achieved in a reasonably short time and at a reasonable cost. The purposes reflect the flexibility needed to allow a company to reorganise its debts 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.[1]

Provisional supervision whether solvent or insolvent

3.9 A company should be able to go into provisional supervision whether it was able to pay its debts or not. A solvent company which recognised that it was 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.[2] We consider that it would be good management practice to act earlier rather than later in initiating provisional supervision and that there is therefore no good reason for excluding solvent companies from the procedure. We note that the Harmer Report made much the same observation and recommendation.[3]

Other jurisdictions

3.10 Purposes expressed in corresponding procedures in other jurisdictions do not differ greatly from our proposed purposes. This is no

1 See paragraph 1.23.
2 Note Chapter 19 on insolvent trading.
3 The Harmer Report, paragraph 56.

coincidence as we have borrowed heavily from other jurisdictions in all aspects of these proposals.

3.11 The 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.[4]

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 could 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.[5]

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.

4 Corporation Law Reform Act 1992.
5 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 recommend that, in addition to the company or its directors, liquidators 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 recommend 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. It was 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 recommendation that the provisional supervisor should take over management control of the company on his appointment and that he should not be answerable to management.[1]

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 would be they who controlled a company and who would be 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 recommend 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.

4.4 We are concerned that the procedure should not be open to abuse. As directors would be the parties most likely to initiate the procedure there could be a danger that some directors would not have scruples about using provisional supervision to their advantage. We consider, however, that this would be unlikely to happen and that the opportunities for abuse would be limited because:

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1 See generally Chapter 8.

(a) initiation of the procedure would actually take control of the company out of the hands of the directors and limit their scope for abuse;

(b) the provisional supervisor would have powers to remove existing directors and to appoint new directors; and

(c) directors would be obliged to file an affidavit with the court.

4.5 Directors could only conceivably use provisional supervision as a vehicle for abuse if they had control of the provisional supervisor. We do not believe that provisional supervisors could be controlled in such a way for the following reasons:

(a) the provisional supervisor would be a qualified professional who would be under a professional and statutory obligations;

(b) the limiting of those professionals qualified to act as a provisional supervisor to a panel operated by the Official Receiver would further reduce any risk in this regard;

(c) a provisional supervisor would leave himself open to investigation in the event of any misconduct; and

(d) the whole basis of the procedure is to provide protection from creditors but only for a limited period, after which the company would have to enter a voluntary arrangement or be wound up.

4.6 We therefore consider that, while there can never be a complete guarantee that the procedure is incapable of abuse, it is unlikely to be abused by directors for the simple reason that it is not an attractive vehicle for directors who want to behave inappropriately.

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

4.7 We recommend that, where a petition has been presented to wind up a company but before a winding up order is made, a provisional liquidator should also be able to initiate the procedure.[2] This recommendation 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 reached this decision, they would have decided that the company was not worth saving and it would seem to be an anomaly to provide for provisional supervision in such circumstances.

[2] See the Companies Ordinance, section 193.

Creditors

4.8 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.

4.9 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. 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, secured creditors could not initiate, they would have the ability to indicate their position to management who should 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.

Receivers

4.10 While we do not see much possibility of it happening, we do not want to exclude the possibility that a receiver might want to convert a receivership into provisional supervision. We therefore recommend that a receiver appointed over the whole or substantially the whole of a company's assets should be able to appoint a provisional supervisor 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. We make the recommendation after some hesitation as it is arguable that there could be a conflict of interest for a receiver turned provisional supervisor in terms of whose interests he served; the creditor who appointed him as receiver or all the creditors of the company. Notwithstanding this, we note that a receiver would not be in a position to change the direction of the receivership and, more particularly, his own role, without the agreement of the creditor who appointed him. If the appointing creditor was prepared to convert to provisional supervision from receivership, it is difficult to see how the conflict of interest argument can prevail.

4.11 We accept that by the time a receiver has been appointed, a secured creditor would 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 instances 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 then let them go under. The reasons behind this have been discussed earlier.[3]

4.12 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, whether receivership or provisional supervision would be the best option. We recommend, nonetheless, that a receiver should have the option to consent to the procedure if he considered that it was the best way to proceed.

Liquidators

4.13 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 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.

Other arrangements under the Companies Ordinance

4.14 We consider that a proposal for a voluntary arrangement under provisional supervision may be made as an alternative 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.[4]

Shareholders

4.15 There was no support for allowing shareholders to initiate provisional supervision. We note that section 168A of the Companies Ordinance already provides shareholders with alternative remedies to winding-up.

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[3] See parahraphs 1.24 to 1.27.
[4] See paragraph 1.4.

Chapter 5

The moratorium (or stay of proceedings)

5.1 As referred to earlier[1] the major drawback of the provision under section 166 of the Companies Ordinance is that during the negotiations there is nothing to prevent a single creditor presenting a petition to wind up a company, thereby frustrating 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 a 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 The moratorium provision settled on, though not complicated, necessarily takes account of the variety of situations that can arise. Consideration was given to limiting the length of time of the moratorium to a maximum of six months but we have concluded that in provisional supervisions involving large companies or complex cases six months would not be enough time for a provisional supervisor to gather all the strands together. Even then, we toyed with the idea of insisting that provisional supervision should end after six months as it would act as an incentive to all parties involved that time was running out after which a company would be left with no option but to go into liquidation.

5.5 We have concluded that to terminate provisional supervision after six 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 six months' work on the altar of

1 See paragraph 1.2.

a quick solution. We therefore recommend allowing the moratorium to continue after six months but only with the approval of the creditors.

Court involvement

5.6 Although a feature of these recommendation is the effort to keep court involvement to a minimum we recommend 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[2] 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 six 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 60 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.

5.11 We have therefore opted for a provision broadly following the model under the Canadian Bankruptcy and Insolvency Act 1992 as we find

2 Insolvency Act 1986, Part II.

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. However, we prefer more flexibility than the extension period the Canadian provisions provide. The initial 30 day period provided for by the Canadian provisions have been followed but we prefer the extensions to be in blocks of 30 days (or longer if required) up to the same maximum of six months from the date of appointment of the provisional supervisor. In addition, we have provided for the moratorium to be extended beyond six months provided creditors are in agreement.

The moratorium

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.

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.

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 an extension or extensions of 30 days or more depending on the provisional supervisor's reports. If the provisional supervisor reports that he is likely to be able to complete the plan but not within a further 30 days, the court should have the discretion to extend the moratorium for any period up to a maximum of six 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 six months from the commencement of provisional supervision.

5.15 The information contained in reports made by the provisional supervisor to the court should not be unnecessarily elaborate and detailed, in order to keep costs and legal procedures to a minimum. What is required is a concise assessment of the company's situation and of the prospects of achieving one of the purposes of provisional supervision within a stated time. This is worth noting because the experience with the reporting provisions under the Insolvency Act 1986 in the United Kingdom caused the Vice-Chancellor in a Practice Note to stress the importance of ensuring that the primary aim of administration orders, that is, to facilitate the rescue and rehabilitation of insolvent companies, is not frustrated by expense, and urged that the costs of obtaining an administration order should not operate as a disincentive to put the process out of the reach of smaller companies.[3]

Provisional supervisor to satisfy the court

5.16 We do not intend that the court should become a rubber stamp for processing extensions to the moratorium. We recommend that the court should only grant an extension to the moratorium period if it is satisfied that the provisional supervisor is acting with due diligence in formulating an arrangement plan, that the provisional supervisor is likely to complete the arrangement plan and 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. Any creditor opposing the extension would have the burden of proving prejudice to himself.

5.17 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.

Effect of the moratorium

5.18 We have identified several types of actions or proceedings that would be subject to the moratorium.[4] 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

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3 Insolvency Rules 2.2 and 2.3. See Practice Note, dated 17 January 1994, in [1994] 1 WLR 160. See the Annotated Guide to the Insolvency Legislation: Sealy and Milman, 4th edition, pages 648 - 649. Note also paragraphs 14.4 and 15.9.

4 But note paragraph 5.25.

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.

5.19 In relation to paragraph 5.18(e), we note that it would be possible for the 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 5.18(e) 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.

5.21 The Consultation Paper proposed that no agreement with the company may be terminated or varied by reason only that a company was in provisional supervision, the purpose being 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, as is currently the practice in bankruptcy and liquidation.

5.22 A submission noted that the proposal would mean that once a company went into provisional supervision, a bank creditor would not be able to accelerate a loan repayable on demand by making a demand or accelerating repayment of a term loan by virtue of provisional supervision being the occurrence of an event of default.[5] The submission considered that whilst this treatment might be appropriate in the context of a provisional supervision, a bank should be able to cancel any commitment in respect of undrawn facilities as this would be a normal consequence of an event of default in most term loan agreements and a provisional supervision would normally amount to an event of default in such agreements. These concerns are noted and accordingly we do not recommend the adoption of such a provision. The arguments made in the submission are ones which all suppliers of goods or services would be bound to echo as no one wants to be forced to do something against his will. We consider that the lack of such a provision would not weaken the procedure as the administration provisions under the Insolvency Act cannot oblige a supplier or lender to continue supplying once a company is in administration. In addition, such a provision would go against the essence of the procedure, which is one of support and persuasion rather than coercion.

[5] Submission of the Hong Kong Association of Banks.

Set-off

5.23 We recommend that a debt should be capable of being set-off in the context of a provisional supervision if it would have been the subject of mandatory set-off under the Bankruptcy Ordinance if the company was being wound up but not otherwise.

5.24 The Securities and Futures Commission submitted that the Securities Ordinance [6] contains requirements for dealers to keep their accounts and to deal with assets owned by them or their clients in a prescribed manner including the setting up of trust accounts to hold clients' assets. The Securities Ordinance, section 85(2), provides that money held in a trust account shall not be available for the payment of debts of a dealer or be liable for execution. Any payment in contravention of this provision shall be void *ab initio* and no title will pass. On the basis of such arrangements, the Securities and Futures Commission takes the view that clients should be entitled to claim from the registered person property belonging to them during the moratorium period. This is important for investor protection, particularly in relation to retail investors who have had their assets tied up. We endorse this view.

5.25 In general terms, trust property held by a company on behalf of another party would not be part of the estate of the company and would not, without the consent of the party on behalf of whom the property is held on trust, be included in any arrangement proposed by a provisional supervisor.

Eligible financial contracts exempted

5.26 In addition to creditors who might be exempted, 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. The central clearing and settlement system of the Stock Exchange of Hong Kong Limited is such a market. 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.

5.27 We have borrowed from the Canadian Bankruptcy and Insolvency Act 1992 in identifying eligible financial contracts. These are:

(a) a currency or interest rate swap agreement,

(b) a basis swap agreement,

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6 See the Securities Ordinance, sections 81 to 85.

(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.

5.28 If an eligible financial contract entered into before commencement of provisional supervision is terminated after the commencement of the provisional supervision and a 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.

5.29 The Securities and Futures Commission noted that the Consultation Paper proposed permitting the netting of obligations between parties to an eligible financial contract and that the effect of this would be to bring the relevant obligations of the parties outside the moratorium. The consequence of this, the Commission noted, would be to allow the parties to net the obligations pertaining to that contract only but not all their mutual obligations, since the latter would result in the discharge of some debts owed to them and give them an advantage which other creditors would not have during the moratorium. We agree with the Commission on this point. In short, it is not intended that the exemption of eligible financial contracts from the moratorium should prevent parties to such contracts from enforcing contractual set-off rights other than those necessary to secure the integrity of the relevant market.

5.30 We also note that it is not intended that set-off should extend beyond the contracts set out in paragraph 5.27.

5.31 The Securities and Futures Commission submitted that it should be noted that in spite of any moratorium, a registered person under the Securities Ordinance or the Commodities Trading Ordinance would be expected to fulfil its duty to advise its clients in relation to the client's investments as long as eligible financial contracts remained outstanding.

Where the creditors' meeting resolves to extend the moratorium

5.32 After the end of six months, the court would cease to have any role in monitoring the provisional supervisor as regards extensions of the moratorium. If the creditors resolved to extend the moratorium beyond six months they could impose such conditions as they wished on the provisional supervisor relating to reviewing the extension. In any event, the provisional supervisor would call a meeting of creditors to consider the matter before the end of six months if he proposed that the moratorium should continue beyond that time.

5.33 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.

5.34 If at any time during such extensions the provisional supervisor decided that he was unable to formulate an arrangement plan within the extension period he should call a meeting of creditors to consider a further extension.

5.35 A creditor affected by the moratorium could oppose an application to the court for an extension of the moratorium but he would have the burden of proving prejudice to himself.

Significant financial hardship

5.36 If the court was satisfied that the moratorium was causing significant financial hardship to the creditor, the court could exempt that creditor from the moratorium and any voluntary arrangement and the moratorium would cease to apply to that creditor and he would 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.

Creditors excluded from the moratorium

5.37 We recommend elsewhere [7] 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.

5.38 A minority of the sub-committee on insolvency considered that the provisional supervisor should not have the power to exclude creditors from the moratorium as it tended to afford him too much power. The minority argued that it would be difficult to attack a provisional supervisor who was not acting in good faith because a provisional supervisor could always argue that he had reformulated his proposal after having excluded creditors.

Crown bound

5.39 The Crown should be treated no differently from other creditors and should be bound as creditor by a moratorium.

Employees[8]

The effect of provisional supervision on employees

5.40 At present, employees are affected in two ways when a company is insolvent. When a company is wound up, employees are entitled to payments from the Protection of Wages on Insolvency Fund Board which administers the Protection of Wages on Insolvency Fund ("the Fund"). The Fund represents a well trodden path for employees, borne out by a statistic from the Official Receiver's Office which shows that in the year 1994/1995 the Director of Legal Aid ("Legal Aid") presented petitions for the winding-up of companies on 38.7% of all cases.[9]

5.41 The usual route followed by employees who seek to have their company wound up is for them to approach Legal Aid for assistance in pursuing claims against an employer. Employees need to take this approach in order to trigger the operation of entitlements under the Fund. In the case of

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7 See paragraph 14.5.

8 See paragraphs 1.20 to 1.22.

9 There were 1,011 petitions presented in the period, 391 of them by the Director of Legal Aid. See annex 5A of the Annual Departmental Report of the Official Receiver's Office for 1994/95.

a company with less than 20 employees, Legal Aid advises the Fund that the company is unable to pay its debts. In the case of a company with 20 or more employees, Legal Aid advises the Fund that a petition has been presented to the court for the winding-up of the company. Based on this, the Fund may satisfy employees in respect of their claims up to certain limits in respect of wages due and unpaid, unpaid wages in lieu of notice and unpaid severance payments.[10] The Fund will then seek to recoup itself in the winding up.

5.42 As the legislation stands, employees who are laid off by a company that does not go into liquidation are not able to make a claim for compensation from the Fund, as the Fund is only triggered by the winding-up of the company or by advice from Legal Aid that the company is unable to pay its debts. On a provisional supervision, employees could therefore be cut out and left without the prospect of any interim payment from the Fund. We consider that it would be desirable for employees who have been laid off as a consequence of provisional supervision to be accommodated under the provisions of the Protection of Wages on Insolvency Ordinance.

5.43 Until that happens, we recommend the introduction of a provision along the lines of section 79 of the Companies Ordinance to the effect that, where a provisional supervisor is appointed to a company the debts of employees which in every winding-up are preferential payments under section 265 of the Companies Ordinance, be paid in priority to all other debts according to their respective priorities under section 265, out of the assets coming into the hands of the provisional supervisor in priority to any other claim.

5.44 Those employees who remain with the company do not represent a particular problem, except in so far as they are owed arrears of wages from before the appointment of the provisional supervisor. Such arrears should be given the same priority given to the wages of employees who have been laid off. Wages payable after the appointment of the provisional supervisor would have to be paid in the normal way. In the event that provisional supervision did not result in a voluntary arrangement and the company went into liquidation, we recommend that employees who remained employed by the company during provisional supervision should be able to claim in insolvency for any wages outstanding before the appointment of the provisional supervisor.

5.45 There is a problem here with the current legislation in so far as it applies to the Fund. Section 265(1) of the Companies Ordinance limits payments from the Fund to services rendered to the company within four months of the commencement of winding-up, in which case an employee who remained with the company would be unable to claim some or all of his arrears from the Fund. An example of the problem would be where provisional supervision continued for the full six months before a meeting of creditors rejected the proposal for a voluntary arrangement and the company

[10] See the Protection of Wages on Insolvency Ordinance (Cap 380), section 2, and Part V and section 265 of the Companies Ordinance.

went into liquidation. As the claims made by employees would be deemed to be claims for arrears of wages that preceded the provisional supervision, that is more than six months before the winding-up, the employees would have no claim against the Fund. We recommend that a deeming provision be inserted in the relevant legislation whereby it is deemed that time does not run in respect of the four months period before the commencement of winding-up in respect of time when the company is in provisional supervision.

New preferential entitlements for employees

5.46 We consider that the preferred rights of employees are now adequately protected. As a consequence of a recent amendment to the Protection of Wages on Insolvency Ordinance, employees are now very well protected in the event of insolvency. The table below sets out the new entitlements for employees which came into operation on 1 February 1996. We would note that these amounts would only apply in provisional supervision to employees who were laid off by the provisional supervisor.

Type of Payment	Maximum amount under the Protection of Wages on Insolvency Ordinance as at 1 February 1996	Preferential limits under the Companies Ordinance
Arrears of Wages	$36,000	$8,000
Wages in lieu of notice	$22,500	$2,000
Severance payment	$36,000 + 50% of excess entitlements	$8,000

5.47 The effect of the new provisions would be that employees laid off by a provisional supervisor would be entitled to claim up to the amounts set out in the middle column from the Protection of Wages on Insolvency Fund. They would become ordinary creditors of the company for any balance. The Protection of Wages on Insolvency Fund would be subrogated as a preferential creditor for the amounts set out in the right hand column and would be an ordinary creditor for the difference between the amount in the right hand column and the middle column.

Adoption of contracts of employment by a provisional supervisor

5.48 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.[11] 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

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

as an expense of the administration in priority to the administrator's own remuneration and expenses.[12]

5.49 The decision resulted in amendments being made to the Insolvency Act[13] 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.

5.50 We recommend that the provisional supervisor should be similarly protected and that provisions in line with the recent amendments to the Insolvency Act 1986 would be appropriate.

End of the moratorium

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

12 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. *Powdrill v Watson, re Leyland DAF Ltd, re Ferranti International plc* [1995] 2 AC 394 HL.

13 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.

Chapter 6

Initiating the procedure

6.1 We have stated above that provisional supervision should usually be initiated by a resolution of the directors or the members of a company.[1] 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 to any great extent 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 recommend 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) 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;

(b) consent to act of the provisional supervisor; and

(c) affidavit of the directors setting out the reasons for initiating provisional supervision.

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. 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.

6.4 It would be necessary to file copies of the resolution, the consent to act and the affidavit of directors in court, in addition to the

[1] See paragraph 4.3. Also see paragraphs 4.10 and 4.13.

Companies Registry, as if the company was subsequently wound up, it would be necessary to fix a date from which winding up should have effect. This would be particularly significant in relation to such matters as fraudulent preferences under section 266 of the Companies Ordinance, which sets a time limit in respect of fraudulent preferences of six 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.

Affidavit of the directors setting out the reasons for initiating provisional supervision

6.5 We have added the requirement that the board of directors of a company should file an affidavit with the court and in the Companies Registry setting out the reasons for initiating provisional supervision and a declaration to the effect that in the opinion of the directors the interests of the company and creditors would be best served by the process of provisional supervision. This provision would be in addition to the other filing requirements proposed by the sub-committee on insolvency.

6.6 The affidavit would be useful to the court in considering later applications for extensions of the moratorium and would also give some reassurance to the creditors. We note that the other documents to be filed would not be sworn whereas an affidavit as a sworn document would carry with it a criminal sanction if it contained misrepresentation or falsehood. An affidavit of the directors would act as an additional safeguard against abuse of the procedure as it would soon become clear to the provisional supervisor and thus to the court if there had been any misrepresentation or falsehood.

Appointment of the provisional supervisor

6.7 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.

Gazetting and advertising

6.8 In any case which stood 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 recommend 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.

6.9 Provisional supervision should 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 English and Chinese language newspapers and in the Hong Kong Government Gazette.

6.10 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 seven 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 not less than two days before the meeting of creditors.

Meetings of creditors

6.11 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 six months of the commencement of the moratorium, or when he decides that none of the purposes of provisional supervision can be achieved.[2]

2 See Chapter 15 for the situations where the provisional supervisor can call a meeting of creditors.

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 and be seen by creditors and employees to be independent of the management of the company and to be skilled in the area of insolvency and company rescue. This is especially relevant in the context of our recommendations 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, and nor may he be easily removed or resign.[1] The role, therefore, is one that requires considerable expertise and integrity.

7.2 In the context of these criteria, the sub-committee on insolvency proposed that only solicitors and accountants should be able to act as provisional supervisors. This was a qualified proposal as, ideally, the sub-committee would have liked to see specialist insolvency practitioners act in the role. The problem was that there is no recognised body of licensed insolvency practitioners in Hong Kong. The sub-committee proposed that when and if a body of licensed insolvency practitioners was established, its members alone should be allowed to act as provisional supervisors. The sub-committee also cautioned that 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.

7.3 We consider that the criteria under which a provisional supervisor may be appointed should be much tighter than that proposed by the sub-committee. We consider that it is vital to preserve the integrity of a company rescue procedure and that the single most important element in achieving this is to provide for the appointment of a provisional supervisor whom all parties could have faith in. It is also important that there should be no scope for abuse of provisional supervision. As provisional supervision would usually be initiated by directors of a company we want to ensure that provisional supervisors would always be independent of the directors and be known to be independent.

7.4 We therefore recommend that in most cases provisional supervisors should only be selected from a panel of practitioners which would be operated by the Official Receiver. There is a precedent for this in operation as the Official Receiver has recently set up an administrative panel of insolvency practitioners for the appointment of firms of accountants as

1 See chapter 11.

liquidators and special managers in court windings-up. It is anticipated that solicitors will be appointed to the panel in due course.

7.5 The basis of appointment to the administrative panel is that a firm must have two qualified practitioners who have either 600 hours over three years or 750 hours over five years of insolvency experience excluding members' voluntary winding-up. There were thirteen firms of accountants on the administrative panel when it went into operation in May 1996. The scheme was based on an Australian scheme that had been in operation for several years.

7.6 We consider that a similarly constituted panel of solicitors and accountants who could act as provisional supervisors would act to reassure all parties to a provisional supervision that their interests were properly represented by the person appointed as provisional supervisor.

7.7 In addition to appointment of provisional supervisors through a panel we recommend that the court may approve the appointment of a person who was not on the panel but who was particularly suited to the task of rescuing a particular company. We consider that this should only happen in exceptional circumstances where the person appointed possesses skills which would not be available on the panel. A disadvantage of appointing an expert who would be able to run an existing enterprise is that he would not necessarily have the expertise to operate a provisional supervision, he would not necessarily be regulated by the code of conduct of a professional body, and he might have practical difficulties in relation to an appointment as provisional supervisor such as obtaining an insurance bond.

7.8 We note, however, that a provisional supervisor would in any event have the power to appoint other people in the performance of his functions or to do any business that may not be conveniently be done by himself.[2]

7.9 Once a provisional supervisor was 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.

Independent person

7.10 We consider that once appointed a provisional supervisor should not be capable of being removed easily. It is important that a provisional supervisor should have the security of knowing that, unless he gives them sufficient cause, parties would be prevented from gaining leverage

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2 See paragraph 8.25.

over him by threatening to have him replaced or by taking up a provisional supervisor's time fighting off challenges to his appointment.

7.11 We received several submissions which argued that there might be occasions where there were good reasons for removing a provisional supervisor. We have accepted these arguments and we recognise that to adhere to a policy of unbending independence ignores the possibility that a provisional supervisor might not be up to a particular job. We accept that there may be instances where it would be appropriate for a provisional supervisor to be removed or where he may resign and we have set out the conditions under which a provisional supervisor may be removed or may resign in Chapter 11.

7.12 We note a proposal 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.

7.13 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 panel of provisional supervisors to function under the rules of their particular profession. 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.[3] We note that the Hong Kong Society of Accountants is likely to give guidelines to its members that the auditors of a company should disqualify themselves from acting as provisional supervisors.

Provisional liquidator as provisional supervisor

7.14 Where a provisional supervision is proposed by a liquidator or a provisional liquidator of a company, he should be able to nominate himself to be the provisional supervisor if he is a member of the panel.

Joint appointment as provisional supervisor

7.15 We recommend that there should be provision for joint appointment of provisional supervisors. There is a precedent for joint appointment in the Companies Ordinance, where section 235(1) provides that a company in general meeting may appoint one or more liquidators for the

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

purposes of winding up the 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 joint appointment is that if one of the liquidators 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. The same should apply to provisional supervisors.

7.16 A submission on the Consultation Paper made the point that the appointment of an individual provisional supervisor may not be practical in Hong Kong where most senior accountants and solicitors have commitments which require them to be frequently out of Hong Kong.[4]

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4 Submission of the Hong Kong Society of Accountants.

Chapter 8

Role of the provisional supervisor

Level of involvement

8.1 The provisional supervisor would operate within tight time constraints in formulating a proposal and 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 If the provisional supervisor was to leave the day to day running of a company in the hands of the management and to limit himself with examining the records of the company and working behind the scenes to formulate a plan there would be a danger on two fronts.

8.3 First, the provisional supervisor might fail to gain the confidence of the creditors if it was perceived that he was not in full control. This problem seems to have arisen in the role of 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."* [1]

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

1 Article in the Irish Times by Eugene McCague, Solicitor, 25th June 1993.

8.5 For these reasons it would not be appropriate to allow management retain full control of a company and accordingly the provisional supervisor should have executive functions. The creditors would be asked to show considerable forbearance during the moratorium. It is important therefore that they should be reassured that the management of a company was not using the moratorium as an opportunity to dissipate the company's assets while the provisional supervisor was occupied in formulating a proposal. In the context of taking over the executive functions of the company, the provisional supervisor would also 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 would bring 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 oblige a provisional supervisor to flood the company with his own people and to reduce the level of involvement of the existing management to a minor role. This is a situation we would 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 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 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;

(j) he should make a report to the Official Receiver if a director of company has been in breach of his obligations under section 168H(1) of the Companies Ordinance, that is, that the director is or has been a director of a company which has at any time become insolvent whether while he was a director or subsequently and that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or companies, makes him unfit to be concerned in the management of a company.[2]

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.

The relationship between the provisional supervisor and the directors

8.9 We have several concerns as regards the relationship between a provisional supervisor and the directors of a company, as the prospects for a successful resolution of a company's problems would be enhanced if the relationship between the provisional supervisor and the directors was well understood and was one of co-operation. This would not happen in some cases but it is worth emphasising the value we place in securing the co-operation of the directors in a situation that would never be comfortable for them.

[2] See section 168I(3) of the Companies Ordinance, which comes under the Disqualification of Directors provisions in Part IVA of the Ordinance.

8.10 Our recommendations contemplate that the existing directors would have recognised that their 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 supervision had been imposed on the directors.

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, once an administration order is made the administrator takes control of all a company's property and of its management and has the power to appoint or dismiss directors.[3]

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.[4]

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, when appropriate.

Advantages and disadvantages of involving the directors

8.14 Directors should 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 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

3 Insolvency Act 1986, section 14.
4 Corporate Law Reform Act 1992, sections 437A and 437C.

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, share holdings 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.

8.17 The directors should be involved in the running of a company, but as we recommend that their powers should vest in the provisional supervisor, it would be in his discretion whether to delegate, and, if so, which powers to delegate back. We recommend 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.

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 that is not in the ordinary course of business of the company;

(f) any guarantee or indemnity on behalf of the company.[5]

8.19 If any director was to allow or permit a company to do any act or thing in contravention of these prohibitions he should be guilty of an offence and be liable to a fine and imprisonment.

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

5 Paragraph 18.8(f) was added following a submission of the Hong Kong Association of Banks.

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 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.

8.21 We recognise, however, that each case would be different. We therefore recommend 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.[6]

Delegation of his powers by the provisional supervisor

8.22 Subject to his overriding duty to supervise the provisional supervision and his stated functions, it would be a proper exercise of his powers for the provisional supervisor to delegate such powers as he considered 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 delegation of day to day powers by a provisional supervisor to directors should be in writing. The provisional supervisor should be able to revoke any powers and duties delegated as he saw fit.

Power to remove and appoint directors

8.23 The provisional supervisor should have the power to remove directors whom he considered were not necessary to the future running of a company. It stands to reason that the provisional supervisor should be able to remove directors whom he considered were not up to their jobs or who are obstructing him in the preparation of a proposal. 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.

6 See generally Chapter 9.

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 was to be able to carry out his functions:

(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;

(b) to appoint an agent or employ any person to do any business which he is unable to do or which may not conveniently be done by 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 and 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 form a committee of creditors;

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

8.26 In relation to paragraph 8.25(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 resulted 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 recommend that this provision should 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.[7]

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. This recommendation 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.

Persons dealing with the provisional supervisor

8.29 Any person dealing with the provisional supervisor in good faith and for good consideration should be protected, in that if the person changed his position or acted to his detriment based on a dealing with a provisional supervisor, the provisional supervisor and the company should be bound by the provisional supervisor's actions whether or not the provisional supervisor was acting within his powers.[8] We consider that this provision is reasonable in order 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.

8.30 The original proposal in the Consultation Paper was that any person who dealt with the provisional supervisor in good faith and for value should not be concerned to inquire whether the provisional supervisor was acting within his powers. We note that the amended recommendation would be more restrictive than the original proposal.

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7 See paragraph 9.4.

8 The original proposal in the Consultation Paper was amended following a submission of the Hong Kong Association of Banks.

Chapter 9

Duties, rights and liabilities of the provisional supervisor

9.1 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.

Liability of the provisional supervisor

Debts which arose before provisional supervision

9.2 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.

Adoption of contracts by the provisional supervisor and existing contracts

9.3 The sub-committee on insolvency proposed that a provisional supervisor should not be deemed to have adopted any contract entered into by a company prior to the commencement of the provisional supervision. No contract entered into by a company prior to the commencement of provisional supervision, however, should be determined or deemed to be determined by reason only that a company was in provisional supervision.

9.4 The sub-committee noted two points. 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 would 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.[1] The sub-committee considered, 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 found that a contract of, for

[1] See paragraph 8.27.

instance, a supply of goods was onerous he should have the power to disclaim it notwithstanding that he had accepted some deliveries.

9.5 We consider that on balance the sub-committee's proposal is correct and recommend this approach to pre-existing contracts. It would be important to provide a provisional supervisor with as much flexibility in dealing with a company's contractual commitments as possible. We considered, however, a proposal that provision should be made to the effect that on a formal request by any person who had entered into a contract with a company in provisional supervision prior to provisional supervision the provisional supervisor should within seven working days of the request confirm whether he intended to affirm, reject, or seek to vary, the contract. The proposal was made on the basis that it would avoid the need to legislate for every contract of the company as a provisional supervisor would only need to make a decision upon request instead of an implied general duty to decide on each and every contract within a reasonable time.

9.6 The argument was made that only contracting parties who were urgently in need of resolving any uncertainly in their contractual position would make such a request and that other parties would be prepared to discuss their contracts informally with a provisional supervisor and await his response in due course. It was also suggested that fixing an exact period for the provisional supervisor to respond to a formal request would provide certainty and would minimise disputes over what constituted a reasonable time. Finally, it was argued that a formal request procedure would safeguard the interests of those contracting parties who were in urgent need to resolve any uncertainty in their contractual position.

9.7 We consider that while there would be some merit in this approach it would not facilitate a provisional supervisor in formulating a proposal or, ultimately, creditors in general. Any provision of a formal request procedure, which in concept would actually be a demand, would probably encourage creditors to force the issue of their contracts with a company in provisional supervision and we fear that an inevitable consequence of a request procedure would result in a provisional supervisor being flooded with formal requests for decisions on contracts immediately a company went into provisional supervision. A request procedure would also probably be used by contracting parties as a tactic to force a provisional supervisor to make a decision on contracts within seven working days.

9.8 Contracting parties who were suffering significant financial hardship as a result of provisional supervision would already be protected under the recommendations[2] and we can see no point in providing further sweeping protection in the form of a request procedure. A formal request procedure could also lead to a provisional supervisor incurring additional expense and could divert a provisional supervisor from the main function of preparing a proposal for a voluntary arrangement.

[2] See paragraph 5.36.

9.9 Again, in this context, we must emphasise that a provisional supervisor would be a highly qualified professional who would be attempting to keep a company in operation. In such circumstances a provisional supervisor would not seek to reject or vary contracts other than contracts that would not benefit a company. A company in provisional supervision must continue to do business and supply and receive goods otherwise the procedure would be pointless. All parties involved would need to be flexible, hence we would prefer to allow a provisional supervisor the flexibility to deal with contracts in whichever way he considered fit.

Disclaimer of onerous property

9.10 We note that there is a difference between the disclaimer of onerous property provisions in the Bankruptcy Ordinance, section 58, and the Companies Ordinance, section 268. Under the Bankruptcy Ordinance a trustee may disclaim in writing without the leave of the court, while a liquidator has to obtain the leave of the court before he can disclaim. We recommend that the Bankruptcy Ordinance provision be followed as it should lead to savings in time and costs over the Companies Ordinance provision.

Fresh debt incurred by the company during provisional supervision

9.11 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 would be paid for their goods or services in full as they would be apprehensive about receiving payment when the existing creditors were 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.[3]

9.12 This problem was identified by the Harmer Report[4] 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 an 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

3 See Chapter 12 on super priority.
4 The Harmer Report, paragraphs 88 to 93.

not apply for the first seven days of the administration.[5] The Corporate Law Reform Act 1992 adopted these recommendations in great part.[6]

9.13 We recommend 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.

9.14 It was submitted that the ability of the provisional supervisor to incur fresh debt which would rank ahead of all other claims should be supervised by a committee of inspection.[7] We are not inclined to impose a committee on the provisional supervisor as it tends to go against our policy of an independent person. We accept, however, that where fresh debt was incurred by the company while in provisional supervision, the provisional supervisor would need to meet from time to time with existing major creditors and with any new lenders during the course of provisional supervision. We therefore recommend providing the provisional supervisor with the power to form such committee of creditors as he thinks fit. The provisional supervisor would thus have the power to have a formal or informal committee of creditors.[8] The committee, if formally appointed, would be expected to act with the provisional supervisor.

9.15 We note that a submission on the Consultation Paper argued for a general committee of creditors which would consider all aspects of the provisional supervision, on the basis that complicated or sensitive issues, not easily discussed at an open meeting of creditors, could be solved by a committee which had the power to resolve all issues except the proposal for a voluntary arrangement.[9]

9.16 We consider that our recommendation that a committee may be formed by the provisional supervisor if he thinks fit adequately covers the position. We are fearful that a facility for the appointment of a creditors' committee with the power to resolve issues would be unlikely to hurry the pace of the proposal and would be more likely to slow it down.

Indemnity

9.17 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, other than claims which are secured by a fixed charge. The indemnity should also be secured by way

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5 The Harmer Report, paragraphs 89 and 90.
6 Sections 443A and 443B.
7 Submission from the Hong Kong Association of Banks.
8 See paragraph 8.25.
9 Submission of Nelson Wheeler Corporate Reconstruction and Insolvency Limited.

of lien over the property of the company and it should have priority over all other securities over the property of the company.

Remuneration

9.18 The provisional supervisor should be entitled to such remuneration as would be agreed between him and whoever initiated the procedure and caused him to act. The level of the remuneration should be specified in a prescribed form in the consent to act.[10] 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, perhaps on a monthly basis. We do not wish to see provisional supervision becoming an opportunity for practitioners to profit to the detriment of creditors and everyone else and hope that this small measure will help to establish a reasonable market rate for the job.

9.19 It is only possible to give guidelines as to how fees should be estimated. We are sure that a provisional supervisor's fees would be of considerable interest to all concerned in a provisional supervision. We recommend that as the Official Receiver should have the responsibility of establishing a panel of practitioners who could act as provisional supervisors, he should also be charged with the task of overseeing the adoption of a fees structure. The fees structure in any particular case would have to be set out in the consent to act form.

Payments for property used by the company

9.20 We note that the sub-committee on insolvency 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 the agreement as was attributable to a period:

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

(b) throughout which:

[10] See paragraph 6.2.

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

(ii) the provisional supervision continued.

9.21 The sub-committee 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. We agree with this view.

Chapter 10

Ascertaining the company's affairs

Information and assistance

10.1 When a 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 appointment, the provisional supervisor should be obliged to investigate the business, property, affairs and financial circumstances of the company with a view to assessing the financial position and deciding, within the initial 30 day period, whether any of the purposes of a voluntary arrangement were capable of being achieved.

10.2 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 had 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.

Specified persons

10.3 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

(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.

10.4 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, imprisonment or both.

Statement of affairs

10.5 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 seven 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.

10.6 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.

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

10.8 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 a company.

Costs of providing a statement of affairs

10.9 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 recommend 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. Such costs and expenses should rank after the payment of the provisional supervisor's fees and expenses.

10.10 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.

Chapter 11

Removal and resignation of the provisional supervisor

Removal of and reporting on the provisional supervisor

11.1 The sub-committee on insolvency proposed that a provisional supervisor should only be capable of being removed by an order of the court for cause shown. It was intended that removal by the court would cover situations where a provisional supervisor was guilty of some irregularity or misconduct in the carrying out of his functions. We note that the Consultation Paper proposed that there should be no provision for the removal of the provisional supervisor. The sub-committee changed its view after receiving several submission which argued in favour of a removal provision. The sub-committee was not prepared, however, to recommend allowing creditors to remove the provisional supervisor by a vote at a meeting of creditors as it considered that this would have the effect of weakening his power to carry provisional supervision through to a proposal for creditors. The sub-committee added that in the case of an unsuccessful application it would expect the court to order that the costs should be paid by the applicant.

11.2 The sub-committee noted that certain safeguards were 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. Before granting an extension, the court must be satisfied that the provisional supervisor was acting with due diligence in his functions. In addition, the provisional supervisor, in seeking an extension, would be obliged to state whether he 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 did 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 As a further safeguard, where a provisional supervision did not result in a voluntary arrangement and the company was wound up, if it appeared to a liquidator that the provisional supervisor was in breach of his obligations, the liquidator should make a report to this effect. Where the liquidator was 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 considered fit and may forward the report to the provisional supervisor's professional body.

11.5 The sub-committee also noted that it would be possible that a provisional supervisor would subsequently become provisional liquidator of a company and then liquidator but this would be unlikely if creditors were unhappy with his performance as provisional supervisor.

11.6 We agree with the sub-committee that a provisional supervisor should only be capable of removal for cause shown. We consider that on balance it is in the interests of the system and in the interests of creditors in general that the provisional supervisor should be protected from threats of removal unless the charges against him are substantial. Merely disliking the way a provisional supervisor was running a provisional supervision should not constitute grounds for removal.

11.7 We have heard arguments that removal for cause shown is too high a standard and that creditors should be able to remove a provisional supervisor if they were dissatisfied with him for whatever reason. It was suggested that it would be appropriate for a provisional supervisor to be removed on a vote of, perhaps, two thirds in value of creditors present at a meeting of creditors as this would provide a balance between the protection of creditors and protection of the provisional supervisor from disruptive creditors.

11.8 It was suggested that the success of a provisional supervision depended on the support of creditors and that an unpopular provisional supervisor could cause the failure of a proposal for a voluntary arrangement. We are inclined to the view that the ultimate consideration of creditors would be the terms of a proposal for a voluntary arrangement and that dislike of a provisional supervisor or his methods would be suppressed if the terms of a proposal were favourable.

11.9 Pragmatic considerations dictate that those on a panel of provisional supervisors must be given every assistance in bringing provisional supervision through to a successful conclusion. The sub-committee on insolvency has always stressed that its main aim was to identify a simple and cost effective procedure. It would upset this aim to provide for challenges to the authority of the provisional supervisor except for the most serious of allegations. If a provisional supervisor was removed, say at a hearing by the court after the initial 30 day stay as a consequence of a vote of creditors, a new provisional supervisor would have to start afresh and familiarise himself with the state of a company and start work on formulating a proposal. We wonder how many companies in provisional supervision could afford to do this.

11.10 We emphasise that notwithstanding that the court's involvement would be kept to a minimum the provisional supervisor would be under the supervision of the court and would also be subject to supervision of the Official Receiver who would operate the panel of provisional supervisors. The requirements for appointment to the panel would be high. We are satisfied that all these conditions would adequately protect the interests of all creditors in a provisional supervision.

Removal from the panel of provisional supervisors

11.11 If a provisional supervisor was removed from a provisional supervision for cause shown the Official Receiver would need to consider whether the provisional supervisor should be removed from the panel. The question of removal from the panel is a question that is best left to the Official Receiver and to the relevant professional bodies to discuss. We consider, however, that if a provisional supervisor was removed from a provisional supervision for cause shown or if a report of a liquidator of a company which had been in provisional supervision was critical of a provisional supervisor, the provisional supervisor should have the right to know the allegations made against him and should have the right of reply.

Resignation of the provisional supervisor

11.12 The role of provisional supervisor would require a high level of commitment and perseverance. The sub-committee on insolvency was 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. The sub-committee did 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 and proposed that he should be obliged to continue as supervisor or liquidator, as the case may be, unless someone else was prepared to take over.

11.13 While we endorse the sub-committee's view that resignation should not be easy we consider that a provisional supervisor should be able to resign without cause shown where a majority of the creditors and the provisional supervisor himself agree to such a course and another provisional supervisor agrees to be appointed to the position. Resignation should not otherwise be possible other than in the circumstances outlined below.

11.14 There are sure to be circumstances where the provisional supervisor would, for exceptional reasons, be unable to continue in office. The 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. The court should only grant leave when it was satisfied that the circumstances were exceptional, where for the provisional supervisor to continue in office would cause severe personal hardship to him, and a replacement had 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. The mere fact that the company has run out of money to pay the provisional supervisor would not entitle the provisional supervisor to resign. In the case of a liquidator acting as provisional supervisor, the notice would be given to the court.

11.15 Where a provisional supervisor died, became mentally incapable, or ceased to be a person who may be a provisional supervisor, the nominator or, if appropriate, the court, should nominate a replacement.

11.16 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.

11.17 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.

11.18 It should be an offence for a provisional supervisor to continue in office when he ceased to be a person qualified to act as provisional supervisor.

11.19 Where a provisional supervisor resigned from office or was removed, the court should consider the circumstances of the resignation or removal and should only release the provisional supervisor from liability for his actions while he was provisional supervisor provided the provisional supervisor had not caused any loss to the company as a consequence of any breach of his obligation or by his misconduct.

Where a company goes from provisional supervision into liquidation

11.20 If a company was to go into liquidation before a voluntary arrangement had been approved, the provisional supervisor, if he was not the liquidator, should pass over all documents and disclose all information obtained by him in the provisional supervision to the liquidator.

Chapter 12

Super priority[1]

12.1 We recommend that provision should be made for a company to borrow during provisional supervision and that such borrowing should receive priority over all existing debts, with the exception of fixed charges. This recommendation is made 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 To satisfy these concerns, where possible, super priority borrowing should come from the existing lenders to the company. Existing lenders should be given a first refusal on any super priority lending the company may require. If existing lenders declined to provide the lending, the provisional supervisor should then be able to seek super priority lending from other sources. Super priority lending would, in any event, probably come from the company's bankers, who would have substantial 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 should have priority to the debts of all creditors subject to the moratorium, apart from loans subject to a fixed charge. 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 provision 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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1 See paragraphs 9.11 to 9.16.

12.5 We note that the Consultation Paper proposed that super priority lending should only come from existing lenders. Several submissions[2] were received on this point which argued that to limit super priority lending to existing creditors could have an effect on the chances of a successful voluntary arrangement, as it may unnecessarily restrict the sources of additional borrowing. Existing lenders would be reassured that super priority lending was not opportunistic as they would have first refusal on any such lending. In practice, the provisional supervisor would liaise closely with the existing lenders, either through a formal committee of creditors or informally, and it is likely that a decision to seek extra funding would be a decision made in conjunction with the existing creditors.

2 Submissions from Dr Larry H.P. Lang, Reader in Finance, of the Chinese University of Hong Kong, The Hong Kong Society of Accountants, the Law Society of Hong Kong and the Securities and Futures Commission all supported this point.

Chapter 13

Secured creditors

13.1 The Consultation Paper proposed that 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 have the right to elect whether or not to participate in a provisional supervision. The proposal was challenged in a submission of the Hong Kong Association of Banks, which stated that the distinction between fixed and floating charges was artificial and would not in all circumstances reflect the level of a creditor's involvement in the company. This argument was accepted by the sub-committee which amended its proposal to one that any substantial charge, whether it was fixed or floating, or a combination of both, should carry the right to elect whether to participate in provisional supervision.[1] The sub-committee noted that, as a matter of practice, if the right of election was limited to floating charge holders only, it would simply lead to the kind of imaginative drafting of charges used to get around the provision as has happened in the United Kingdom.

13.2 The proposal in the Consultation Paper distinguished floating charges from fixed charges, and excluded fixed charge holders from the right of election, on the basis that fixed charge holders would not be jeopardised by provisional supervision to the same extent as floating charge holders. The Consultation Paper argued that, as fixed charges attach to property, which is defined in the debenture creating the charge, and the chargor, in this instance the company seeking provisional supervision, is not able to deal with the property without the consent of the chargee, there was not the same potential exposure to a downturn in a company's performance as in the case of a floating charge.

13.3 While a fixed charge generally attaches to fixed property, a floating charge is an equitable charge on the assets of the chargor, which allows the chargor to deal with the charged assets in the ordinary course of business without requiring the consent of the chargee every time the chargor wishes to deal with them. A floating charge crystallises into a fixed charge, and attaches to the assets specified in the debenture, on the happening of certain specified events, usually the appointment of a receiver or a liquidator.

13.4 The sub-committee originally considered that, as assets covered by a floating charge were more likely to be eroded when a company suffered financial difficulties, floating charge holders should have the right to elect whether to participate in a provisional supervision as their exposure would

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[1] See paragraph 13.8.

tend to be more severe. The sub-committee noted that in practice, however, fixed or floating charges may be created over the same assets, a case in point being the existing and future book debts of a company. The distinguishing feature between fixed and floating charges is not necessarily the nature of the asset secured by the charge but the nature of the charge or debenture created over the asset.[2]

13.5 The treatment of secured creditors is a pivotal issue in the creation of a provisional supervision procedure. The Consultation Paper stated that there was no avoiding the rights of secured creditors and their importance in the world of business. The sub-committee stated that it did not intend to radically alter those rights as to do so would result in the major source of secured lending, the banks, opposing these proposals. The sub-committee considered that the whole procedure, essentially, was 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 and 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, the sub-committee proposed that floating charge holders should not be forced into the procedure but should be given the option to elect to remain outside the procedure. The probable consequence of such an election would be to end any prospect of a voluntary arrangement.

13.6 The proposal that all holders of substantial charges over the assets of a company simply should have the right to elect would do away with any anomalies that may have arisen in the treatment of charge holders. The creation of a distinction between fixed and floating charges would be taken into consideration by lenders when creating charges and would have had an effect on the terms of lending, including the level of interest charged on loans.

13.7 We endorse the sub-committee's view that it would have been artificial to distinguish between the rights of floating and fixed charge holders for the purposes of provisional supervision. It is an aim of the procedure to fit in with the prevailing conditions, not to change them. We therefore recommend that that any substantial charge, whether fixed or floating, or a combination of both, should carry the right to elect whether to participate in provisional supervision.

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2 See, for example, *re New Bullas Trading Ltd* [1994] BCC 36, where the English Court of Appeal considered a charging instrument which created two separate and distinct charges; one a fixed charge over future and existing unrealised book debts, the other a floating charge over monies received from debtors. The Court of Appeal held that even though the chargor was able to deal freely with monies received from debtors, that did not invalidate the fixed charge on the unrealised book debts. See also *re Armagh Shoes* [1984] BCLC 405 (NI) and *re Brightlife Ltd* [1986] BCLC 418.

Right of election for major secured creditors

13.8 We recommend that a major secured creditor, that is, the holder of any charge over the whole or substantially the whole of a company's assets, whose level of exposure or lending 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 whether or not to participate in the provisional supervision.

13.9 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.

13.10 If major secured creditors elected to participate, or make no election within three working days of receipt of the notice of election, provisional supervision should continue and the major secured creditors would be subject to provisional supervision. We have amended the proposal in the Consultation Paper to three "working" days after a submission suggested that three days was too short.[3] We accept that three days would be too short if the notice was served on a Friday with an election required by the following Monday, but we are concerned the process must move quickly. We have taken account of situations where a decision on whether or not to elect would have to be referred to an overseas head office by a secured lender. We take the view that, while time differences may create some problems, three working days should be sufficient time to allow a decision to be made, taking into account the speed of communications that now exists. For all these purposes, we would not consider Saturday to be a working day.

13.11 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.

13.12 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 done deal.

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3 Submission of the Hong Kong Monetary Authority.

13.13 We note that 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.[4] 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

13.14 Other secured creditors, that is, holders of charges whose level of exposure or lending would not warrant a 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 would not be feasible to allow creditors secured for less significant amounts of lending 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 recommendations, 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.

Lightweight charges

13.15 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.[5] 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 1986, the charge holder could also appoint an administrative receiver.[6]

13.16 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

4 A view supported by a submission of the Hong Kong Society of Accountants.
5 For a full discussion, see "Lightweight Floating Charges" by Dr Fidelis Oditah [1991] JBL 49.
6 Insolvency Act 1986, section 28(2).

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 effect of his appointment and the moratorium would remove two vital rights from the chargee, the ability to control the timing and conduct of realisation of his security.

13.17 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. We consider, however, that since we make no distinction between the rights of fixed and floating charges in terms of the right to elect whether to participate in provisional supervision the problems created by lightweight charges should be diminished.

Provisional supervision should complement existing procedures

13.18 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 would not be possible, however, to successfully operate provisional supervision without a moratorium to protect a company while a proposal was 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 was 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.

Timing of charges

13.19 Where a company is in provisional supervision, any charge on the undertaking or property of the company created within 12 months of the commencement of the provisional supervision should, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to the amount of any cash paid to the company at the time of or subsequently to the creation of, and in consideration for, the charge, together with interest on that amount at the rate specified in the charge or at the rate of 12 per cent per annum whichever is less.

Chapter 14

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

Provisional supervisor to decide whether a voluntary arrangement could 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 had ascertained the financial position, to decide whether the purposes of a voluntary arrangement were 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 would have to advise the court that he would be likely to complete the arrangement plan within the period of the extension. If he had not formed the view that a voluntary arrangement could be achieved he would be unable to make this representation.

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 believed could be of assistance.

If a voluntary arrangement could be achieved

14.3 If the provisional supervisor decided that any of the purposes of a voluntary arrangement were capable of being achieved he would proceed to prepare a draft voluntary arrangement plan for consideration by creditors, within the initial period of 30 days if possible.[1] 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 A submission on the Consultation Paper suggested that while the actual details of a rescue plan would vary depending on the particular

[1] See generally paragraphs 15.7 to 15.18.

circumstances of each case, there would nevertheless be features common to every plan and that, accordingly, the contents of the plan should have as a minimum the documents set out in paragraph 15.8. We do not agree.[2] Our concept of a draft arrangement plan is of a concise statement of the proposed voluntary arrangement which should be capable of being understood by an average creditor in a reasonably short time. If a creditor wanted to see the reports and statements, we note that they would be available for inspection at the provisional supervisor's office for studying the draft arrangement plan in more detail. To supply the documents in paragraph 15.8 would add unnecessarily to the expenses of the provisional supervision.

14.5 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 agreed. Once agreement had 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 would be 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.[3]

14.6 When the provisional supervisor formulated a plan he should call a meeting of creditors to consider it. If, having commenced the formulation of a plan, the provisional supervisor found that he could not complete it, he should report to the creditors that he was unable to formulate a plan.

If a voluntary arrangement could not be achieved

14.7 If the provisional supervisor decided that none of the purposes of a voluntary arrangement could be achieved he should call a meeting of creditors to inform them.[4] The meeting should be held without delay and the notice of meeting should state that it was being held to consider the decision of the provisional supervisor that none of the purposes of a voluntary arrangement were capable of being achieved.

14.8 The meeting should resolve to terminate provisional supervision and to wind up the company as a creditors' voluntary winding up and appoint a liquidator.

14.9 When he called 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 considered that a voluntary arrangement could not be achieved. These documents should be available

2 See paragraph 5.15 but also see paragraph 15.9.
3 See paragraph 5.37.
4 See generally paragraphs 15.5 and 15.6.

for inspection at the provisional supervisor's office.

14.10 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.

14.11 If the creditors resolved 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 six months limit for fraudulent preferences under section 266 of the Companies Ordinance.

14.12 The provisional supervisor 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 would be 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.[5]

14.13 If a provisional supervision was terminated because the creditors had 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.[6]

No quorum

14.14 If there was no quorum at the meeting it should be deemed that the company should be wound up as a creditors' voluntary winding up.[7]

5 See paragraphs 11.12 and 11.13.

6 This provision would apply to any termination of provisional supervision and subsequent winding-up.

7 See paragraph 16.28.

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 could 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 could be reached. This should prevent meetings from becoming side-tracked because if a meeting could not 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 was agreed it would be more likely to succeed if there was 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 could be made, and the reporting requirement on the provisional supervisor, as they would vary in each case.

15.3 The different circumstances are (i) where the provisional supervisor was satisfied that he would complete the formulation of an arrangement plan, (ii) where it appeared to the provisional supervisor that he would be able to complete the formulation of an arrangement plan but not within six months of the commencement of provisional supervision, and (iii) where the provisional supervisor decided that none of the purposes of provisional supervision could be achieved.

15.4 For all of these types of meeting there are common provisions, such as that creditors should form a single class and seven days' notice in writing of the meeting should be given by the provisional supervisor. We also recommend 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 decided that none of the purposes could be achieved

15.5 In this situation, previously referred to in paragraphs 14.7 to 14.13, the notice of meeting should inform creditors of the resolutions that could be made at the meeting and that the following documents were 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 were capable of being achieved.

15.6 The meeting should resolve:

(a) to terminate the provisional supervision; and

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

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

15.7 Where the provisional supervisor is satisfied that he would complete the formulation of an arrangement plan he should call a meeting of creditors to consider the completed plan.[1] A notice of the meeting should be sent to all creditors who had not been excluded from the provisional supervision and who appeared in the statement of affairs, and any other creditors known to the provisional supervisor.

15.8 The notice should inform creditors of the resolutions that could be made at the meeting and that the following documents were 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 projected cash flow statement,

1 See paragraphs 14.3 to 14.6.

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

(d) a draft arrangement plan.

15.9 A submission on the Consultation Paper suggested that the notice to creditors should contain a summary of the main features of the plan. We agree, as this would facilitate creditors' understanding of the proposed plan in advance of the meeting and would lead to a greater understanding of the proposal by creditors at the meeting.[2]

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.

15.11 An arrangement plan would be deemed to have been approved when the resolution approving the arrangement plan was passed. The provisional supervisor would have to consent to any modification to the arrangement plan.

Where it appeared to the provisional supervisor that he would 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 six months from the commencement of provisional supervision.[3]

15.13 The notice should inform creditors of the resolutions that could be made at the meeting and that the following documents were 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

2 Submission from the Hong Kong Society of Accountants. Note paragraphs 5.15 and 14.4.
3 See also paragraphs 14.3 to 14.6.

informed decision,

(b) a projected cash flow statement, and

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

15.14 The meeting of creditors should be able to 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 should be wound up and a liquidator appointed.

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

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

15.17 A meeting to review an extension should resolve to:

(a) continue the extension, or

(b) terminate the extension and that the company should be wound up and a liquidator appointed.

15.18 As a final safeguard, if the provisional supervisor found 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.

Chapter 16

Procedures for meetings of creditors

Classes of creditors

16.1 The main problem 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. We recommend that at any meeting of creditors to consider any matter relating to provisional supervision, creditors should form one class.

16.2 We note that the sub-committee on insolvency examined the question of whether creditors should vote in classes or vote as one class. The sub-committee proposed by a majority that creditors should form one class. We reproduce the arguments involved below.

Separate classes

16.3 The sub-committee decided early in its 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. The sub-committee envisaged that, in most cases, there would be at least two classes, secured and unsecured creditors, but felt that it was probable other classes would emerge. These could include employees and other preferential creditors, secured creditors who had a right of election, those that did not, and suppliers.

16.4 The sub-committee 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, the sub-committee 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 was 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 considered 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.

16.5 The majority of the sub-committee believed that provision for separate classes of creditors would not work under the proposals as they would act against the concept of a cheap, quick and efficient system. The sub-committee found time and again in discussion that classes had an impact on just about every aspect of the procedure and tended to create unwanted complexity. The majority considered 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 it 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 or the company would be forced in liquidation. 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.

16.6 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.

16.7 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.

16.8 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 six months or less, the need to put his proposal to a number of different interests, any one of which could reject the proposal, 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

16.9 In contrast, a single meeting of creditors, for both secured and unsecured creditors, was a clearer and simpler option. The majority of the sub-committee considered that the proposals offered adequate protection for all creditors' interests in the requirement that, for a resolution to be approved on a proposal for a voluntary arrangement, there would have to 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 were likely to possess the bulk of the debt and it would also protect smaller creditors, who should outnumber the secured creditors.

16.10 The submissions received on this issue were fairly muted. One submission suggested that it was possibly the most difficult area of the proposals and commented that self interest would dictate the actions of major secured creditors with adequate security, as they would have no incentive to elect to participate in the moratorium. The submission was inclined to discount the prospect of major secured creditors looking at the bigger picture of the hope of continuing a business. The submission said that, for unsecured creditors, the position would depend on the actual insolvency of the company and its prospects of returning to normal activities and that, usually where finances were doubtful, it was in the interests of unsecured creditors to see what could be done, rather than to force the issue. It was submitted that, although a system which recognised those competing interests would be more complicated, it seemed fairer to do so.[1]

16.11 Another submission suggested that an alternative might be to have all creditors form one class but for voting purposes only to be based on the amount of the unsecured debt. Thus the secured creditors would value their security and would only vote to the extent, if any, of their unsecured debt. This would give greater weight to the views of unsecured creditors, who would have the most to lose.[2]

16.12 We are encouraged that the Hong Kong Association of Banks, whose members would be likely to congregate in the ranks of secured creditors, expressed sympathy for the proposals on single classes of creditors. We are aware that the self interest of major secured creditors could defeat the prospect of provisional supervision followed by a voluntary arrangement. We do not want to interfere any more than necessary with secured rights and we do not see how a provisional supervision could succeed unless it was supported by the major creditors from the outset.

16.13 By extension, we believe that once unsecured creditors saw that major secured creditors had put their weight behind a provisional supervision they would be encouraged to vote for participation in a voluntary arrangement. The whole procedure would rely on the acknowledgement of the parties that a company was worth saving. Initially, the impetus for saving a company would come from its directors with the support of the major secured creditors, who would have a detailed knowledge of the companies circumstances. They must then, through the provisional supervisor, put together a proposal satisfactory to all interests. The final act would be the meeting of creditors, where the unsecured creditors would have their first real say in the process. They would vote on the basis of the proposal in the knowledge that the company had traded on during the moratorium, that they had been paid by the provisional supervisor for whatever services they had provided during the moratorium, and that the prospects of being paid in the future by a company that was again on a sound financial footing were as good as any. The breathing space of up to six months, for a company which would otherwise be in liquidation, could make a huge difference to the company and the perception that the creditors had of it.

1 Submission of the Bar Association.
2 Submission of the Hong Kong Association of Banks.

Other jurisdictions

16.14 In Canada 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 report by the Superintendent of Bankruptcy in Canada on the first year of operation of the procedure made 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.

16.15 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 and 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.[3]

16.16 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

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[3] 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."

same period the previous year. By mid-July 1993 some 71% of the proposals were still surviving, indicating a good start for the procedure.[4]

16.17 Alternatively, we were interested to note that recent proposals in the United Kingdom for a new company voluntary arrangement procedure did not even mention the introduction of classes.[5]

16.18 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 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.

16.19 In Australia, the Corporation Law Reform Act 1992 provides for a single meeting of creditors to decide on a company's future.[6]

Chairman

16.20 The provisional supervisor, or one of the provisional supervisors, 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.

Notices

(a) General Notices

(i) Notice to creditors of claims

16.21 One of the first actions the provisional supervisor should take would be to advertise a notice to creditors, who had given due notice of their claims and were still subject to the provisional supervision, asking them to

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4 "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.

5 The Department of Trade and Industry, Insolvency Service, Consultative Document on Revised Proposals for a New Company Voluntary Arrangement Procedure. April 1995.

6 Corporation Law Reform Act 1992, sections 439A to 439C.

give notice in writing of their claims within seven days of publication of the advertisement. This relates to the tight time limits the provisional supervisor would face and to the need for him to establish as soon as possible the extent of the company's liabilities. We consider that seven days should give sufficient time for most creditors to file a claim. Generally, all types of notice should be seven days, for the same reasons.

16.22 The option was for a period of between five to 10 days, with seven 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 recommended 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.[7]

16.23 Nonetheless, there may be creditors who had not been traced who come forward at a later date. This would not affect their claims, as they could be admitted at any time, or their rights to vote at the meeting. They should, however, be bound by the terms of any voluntary arrangement accepted by the creditors at a meeting.

16.24 The notice should be published in one English language and one Chinese language newspaper published in Hong Kong. These time limits mean, unfortunately, that there could be insufficient time to advertise such notices in the Gazette as the Gazette is published on a Friday and, at present, notices must be lodged with the publisher on the Monday preceding publication.

(ii) Notice of meeting of creditors

16.25 Meetings of creditors should also be advertised in newspapers under the same conditions as above, giving creditors seven 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 two days before the meeting.

(b) Personal Notices

16.26 The provisional supervisor should give all creditors whose claims were known to him, and whose addresses were known to him, seven days notice in writing of the meeting of creditors. The notice would apply 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.

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7 See paragraph 6.10.

16.27 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 were available at his office for inspection. A submission was received on the Consultation Paper, which we endorse, that the contents of notices should contain the text of any resolutions to be proposed at a creditors' meeting.[8]

Quorum

16.28 The quorum for any meeting of creditors should be one creditor present and entitled to vote If there was 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 as a creditors' voluntary winding up.[9]

16.29 The Consultation Paper proposed that three creditors should be necessary for a quorum. A submission was made that, for the purposes of harmonising the laws of bankruptcy and corporate insolvency, the recommendation in the Commission's Report on Bankruptcy that only one creditor would need be present to constitute a quorum should be followed. We accept the point.[10]

Proxies

16.30 At any meeting, creditors should be entitled to vote either in person or by proxy. Creditors should be able to give a general proxy in favour of anyone attending the meeting apart from the Chairman or provisional supervisor[11], who should only be able to act on specific proxies in favour of or against the resolutions of the meeting. We consider that it would be wrong to provide the Chairman or the provisional supervisor with general proxies as they would be obliged to vote in favour of any resolutions.

16.31 We also recommend that general and special forms of proxy should be sent with every notice to creditors. A creditor should be able to appoint the provisional supervisor, or the Chairman if he was not the provisional supervisor, to act as his special proxy only, that is, in respect of a resolution where a creditor specified his support or opposition to the resolution, as the effect of giving the provisional supervisor or the Chairman a general proxy would be a vote in favour of resolutions put to a meeting by, for the most part, the provisional supervisor. A creditor may appoint any other person to act as his general proxy.

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8 Submission of the Hong Kong Association of Banks.

9 See paragraph 14.14.

10 Submission of the Hong Kong Society of Accountants. We note, however, that Rule 123 of the Companies (Winding-up) Rules currently provides for a quorum of three.

11 See paragraph 16.20.

Adjournments of meeting

16.32 In a case where the provisional supervisor was satisfied that he could 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.

16.33 Where the provisional supervisor believed that he would be able to complete a plan but not within the six months, the meeting of creditors called to consider the matter may adjourn the meeting to a later date, not exceeding the six months, if they resolved to extend the moratorium.

16.34 Where the provisional supervisor found that none of the purposes of provisional supervision could be achieved, the meeting could not be adjourned.

Voting

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

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

16.37 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 recommending that the majority in value should be three quarters but followed the Canadian provisions in adopting two thirds.[12] 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.

16.38 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,

[12] 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.

for example, provides for a resolution to be passed by a majority in value of those present and voting.[13]

16.39 We note that a problem arose recently under the Insolvency Act[14] 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[15], 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.

16.40 The creditor succeeded in her claim on the basis that there was a material irregularity in the conduct of the meeting.[16] In a more recent case[17], 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.

16.41 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 recommend that any valuation put on an unliquidated claim for the purposes of voting by the chairman should not be overturned by the court unless it is manifestly unreasonable.[18]

Implementation of creditors' resolutions

16.42 Where a voluntary arrangement plan had been approved by creditors that were 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

13 Insolvency Rules 1986, rule 2.28(1) but note rule 2.28(1A).
14 Insolvency Rules 1986, rule 1.17(3).
15 *Re Cranley Mansions Ltd* [1994] BCC 576.
16 Under the Insolvency Act, section 6(1)(b).
17 *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.
18 We consider that the Insolvency Rules, rule 1.17(1) to (6) should be adopted into the provisions subject to any amendments that are necessitated by our comments in the preceding paragraphs. Rule 1.17(7) may be adapted to provide that the Chairman's decision should not be reversed or varied unless the court takes the view that the original decision was manifestly unreasonable and only if the court considers the matter as such to give rise to unfair prejudice or material irregularity.

who was entitled to vote at a meeting at which the arrangement plan was approved, and on the company and its members.

16.43 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.

16.44 If the provisional supervisor was not also the supervisor of the voluntary arrangement he should be obliged to do all things necessary to facilitate the transfer of office.

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 would need protection. It should be a condition of every voluntary arrangement that, while it was 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 recommend 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.

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

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 prospered. This should act as an incentive for these creditors to do new business with the company.

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

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.

Chapter 18

The supervisor of a voluntary arrangement

18.1 The supervisor of a voluntary arrangement should only be capable of appointment from the Official Receiver's panel. In most cases he would probably be the provisional supervisor.

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 was 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.

18.3 The supervisor may require any officer of the company or any employee of the company who in his opinion was 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.

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 failed to comply with any request from the supervisor should be guilty of an offence.

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.

18.6 If any party to the voluntary arrangement was 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 directions, remove the supervisor from office or make any other order it thought fit.

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.

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

18.9 If a new supervisor was appointed or if the voluntary arrangement ceased 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.

Chapter 19

Insolvent trading

Introduction

The main features

19.1 The sub-committee on insolvency proposed the introduction of a provision which would have imposed a liability for insolvent trading on certain responsible persons, that is, (i) directors and (ii) senior management of a company which acted in the place of or on behalf of the directors or who took decisions which directors might normally be expected to take. The proposal was that 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 substantially accept the sub-committee's proposals in so far as they relate to directors but we do not accept that senior management should have the same duties imposed on them as would apply to directors for the reason that senior management do not have the ability to initiate provisional supervision or to wind-up a company. We therefore recommend that a lesser duty should be imposed on senior management in the event that they considered that a company was trading while insolvent.[1] The duty of senior management would involve a reporting or notice requirement which if complied with would protect senior management from liability for insolvent trading.

Provisional supervisor

19.3 We recommend that a provisional supervisor should be protected from liability for insolvent trading. This is necessary because no professional person would be likely to act as provisional supervisor if he and his fellow partners were exposed to such extensive liability. It should also be recognised that the provisional supervisor would be a professional person who would be expected to act in a responsible manner.

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1 See paragraphs 19.15 to 19.41.

Presumptions

19.4 We recommend 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 had not been kept.

Defences

19.5 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 a guide for responsible persons on how to act when a company traded into difficulties.

The reasoning

19.6 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 as having attempted to save a company or as having traded while insolvent.

19.7 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 paid attention to their business, and who took appropriate action when faced with insolvency, should never face an application in respect of insolvent trading, whereas those who did not would be vulnerable.

The costs involved in an application for insolvent trading

19.8 We do not expect that there would be a flood of applications 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

[2] Insolvency Act 1986, section 214.

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

19.9 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 employed a lower standard of proof than fraudulent trading.[5]

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

19.10 We can see no reason for making an application for insolvent trading unless a company has gone into insolvent liquidation. In practical terms, in the case of a company which remained in business 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 through the courts.

19.11 The power to make an application should vest in a 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.

19.12 Under the parallel new Australian provisions[6], 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 a 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

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3 The Companies Act 1948, section 332.
4 The Cork Report, paragraph 1776.
5 See paragraph 19.114.
6 Corporations Law, sections 588R to 588U.

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.[7]

19.13 A submission suggested that the provisional supervisor, or the supervisor of a voluntary arrangement, should be able to make an application for insolvent trading when a company was insolvent as it would be in the interests of an insolvent company for its assets to be maximised and it would not really matter whether it had finally been put into liquidation.[8] We consider, however, that a provisional supervisor should be left as free as possible to concentrate on a proposal for an arrangement and that consideration of liability for insolvent trading should be left to a liquidator if one is subsequently appointed. In this context we note that there is no requirement imposed on receivers to report on fraudulent trading. We are also concerned that directors and other responsible persons should not be discouraged from going into provisional supervision by the thought of the provisional supervisor having an obligation or power to look to them for compensation for insolvent trading. The two concepts of encouraging directors to look for help while at the same time leaving them open to insolvent trading liability do not sit well together.

Payment of compensation for insolvent trading

19.14 We recommend that liability for insolvent trading should be 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 the company. This should not prevent proceedings from being instituted in respect of a breach of such a duty or in respect of such a liability.

Directors and senior management should be liable as responsible persons

19.15 We recommend that directors and senior management should be responsible persons who would be liable to pay compensation to their company if they are found by the court to have failed in their respective duties by permitting the company to trade while insolvent.

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7 See paragraphs 19.84 to 19.86 and 19.88 on indemnity and assignment of debts.

8 Submission of the Hong Kong Association of Banks.

Directors

19.16 We recommend that directors of a company should be liable to pay compensation if the company traded while insolvent. The difficulty lies in pinpointing those who should be considered to be directors of a company for the purposes of insolvent trading and then making the provision effective against them. We have taken a broad approach 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.

19.17 Insolvent trading should apply to all directors whether they were validly appointed directors, persons who held themselves out to be directors though they had not been validly appointed, and shadow directors.[9]

19.18 We recommend that any provision on insolvent trading should define directors in sufficiently broad terms to include persons who hold themselves out to be directors. In this context we note section 2 of the Companies Ordinance in which director is defined in the following terms:

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

Shadow directors

19.19 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 limited in its application to Part IVA of the Companies Ordinance, which provides for the disqualification of directors. We recommend that this definition be extended to any provision on insolvent trading subject to the following proviso.[10]

19.20 We note that under the existing law a person would only be considered a shadow director if the whole of the board or at least the

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

10 We note that there are other instances under the Companies Ordinance where shadow directors are relevant. Section 158(10)(a) provides that "*a person in accordance with whose directions and instructions the directors of a company are accustomed to act shall be deemed to be a director and officer of the company*"; this in relation to the register of directors and secretaries. Section 351(2) provides that, under the section, "*any person in accordance with whose directions or instructions the directors of the company are accustomed to act*" may be an "*officer who is in default*" under the section.

governing majority of the board were accustomed to act on that person's directions. The effect of this is that if someone controls one director or a minority of the directors of a company he is not a shadow director.

19.21 In a normal business situation there is merit in such a distinction since the directors of a company would generally act collectively as the board and their liabilities would generally be collective. This is not the case with our recommendations where potential liability for insolvent trading would be on the basis of the individual actions of directors. Each director would have a distinct and separate duty and obligation to prevent insolvent trading and the courts may make a different finding in respect of different directors of the same insolvent company.

19.22 We anticipate that it would not be sufficient to extend the definition of shadow director in section 168C of the Companies Ordinance to the insolvent trading provisions as it might be possible for directors to avoid personal liability for insolvent trading through the appointment of a nominee company as the director. For example, Mr A and Mr B assign their respective nominee companies C and D as the directors of Company X but Mr A and Mr B attend all the directors' meetings of Company X personally as representatives of C and D. Under the existing law on shadow directors neither Mr A nor Mr B would be considered the director or shadow director of Company X although they were the real and effective directors.

19.23 We can see no reason why Messrs A and B should not be considered as the directors of Company X for the purposes of insolvent trading and recommend that for the purposes of insolvent trading the definition of shadow director should be extended to include any person in accordance with whose directions or instructions a director of a company is accustomed to act.

Holding companies

19.24 We have not made any recommendation in relation to holding companies in the context of insolvent trading. The question of whether holding companies should be open to liability in the event of insolvent trading by a subsidiary was considered but the Commission was unable to reach a firm conclusion and had no settled view. The arguments for and against imposing liability on holding companies are set out below. [11]

Executive and non-executive directors

19.25 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

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11 See paragraphs 19.92 to 19.113.

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.

19.26 A submission made the point that directors, particularly non-executive directors, could be misled by creative accounting in the preparation of financial statements, presumably by other responsible persons.[12] We consider that if a responsible person had been deliberately misled by other responsible persons, he would not be held liable for any insolvent trading that occurred provided he could demonstrate that he had been misled and that he had been reasonably diligent in the performance of his duties.

Nominee companies

19.27 A common practice 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 should be able to look to the individuals behind the nominee company in respect of an application for insolvent trading. This issue has been addressed above in our recommendations on shadow directors.[13]

The position of individual directors

19.28 We recommend 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. A responsible 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.

19.29 A boards of directors will not always agree that a company is trading into insolvency and some directors, whether because of their particular expertise or for other reasons, will anticipate the problem before other directors. Such directors would face a dilemma as to what to do.

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12 Submission of the Hong Kong Society of Accountants.
13 See paragraphs 19.19 to 19.23.

Diligent and responsible directors should be encouraged to stay on the board rather than resign and should be reassured that even if the company traded while insolvent personal liability should not attach to them. In any event, many directors would be executive directors with employment contracts with the company and could be tied to a notice period which would prevent early resignation.

Senior management

The sub-committee on insolvency's proposal

19.30 The sub-committee on insolvency proposed that the senior management of a company should be equally liable for insolvent trading and should have the same duties and obligations as directors. It was proposed that the management of a company which acted in the place of or on behalf of the directors or who took decisions which directors might normally be expected to take should be liable for insolvent trading if they failed to take appropriate action when a company was trading while insolvent.

19.31 The sub-committee considered that it would be desirable in the context of business practice in Hong Kong to include senior management in the provision, as it is common for oversea companies with subsidiary companies in Hong Kong to leave locally appointed management in control of local operations. The sub-committee noted that many subsidiary companies seldom hold board meetings and that oversea parent companies rely on reports from local management to keep track of how a Hong Kong subsidiary was faring. The sub-committee considered that 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 and the senior management would be liable for failing to prevent the company from trading while insolvent.

19.32 The sub-committee felt that senior management may know the day to day financial position of a company as well as the directors and that if senior management found that a company was in danger of trading into a situation of insolvency, it should warn the directors as soon as possible. Provided senior management took appropriate action in warning the directors and in advising the directors on appropriate action, the sub-committee considered that they should not be liable for insolvent trading. If the board of directors then failed to take appropriate action and instructed senior management to take a course of action that resulted in insolvent liquidation, senior management should not be liable. Again, as with the responsible director, senior management should document its opposition to such a course of action. The sub-committee considered that it might have been 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 resigned or remained with a company, they would have to be careful to document their actions from the moment that they anticipated insolvent trading, as resignation alone might not have constituted an adequate defence.

Senior management's duties in respect of insolvent trading should be different to the duties of directors

19.33 We agree with the sub-committee that senior management should be liable to pay compensation for insolvent trading if they failed to take appropriate action to warn the board of directors that the company was trading into insolvency. We consider, however, that it would be too harsh to impose the same duties imposed on directors, which are set out below[14], because directors and senior management have different functions within a company.

19.34 While senior management might recognise that a company was trading while insolvent it would still be obliged to act on the instructions of the board of directors. In addition, the power to wind-up a company voluntarily or to initiate provisional supervision would only lie in the board of directors.

19.35 We therefore recommend that senior management should be under a duty to warn the board of directors that a company is or is about to trade while insolvent.

19.36 The sub-committee on insolvency considered that it was not necessary to define senior management beyond a statement that management of a company which acted in the place of or on behalf of the directors or who took decisions which directors might normally be expected to take should be considered to be liable for insolvent trading. The sub-committee considered that no further definition was necessary as it could be left to the court to decide whether a person was a senior manager.

19.37 We take the view that it would be helpful to companies to provide guidelines as to what would constitute senior management and recommend that liability should be limited to those managers who were involved to a substantial or material degree in the direction of the company. In other words, liability should extend to those in management who would know, who ought to have known or who had reasonable grounds for suspecting that a company was insolvent or would become insolvent and failed to warn the board of directors of the situation.

Valuation of a company's assets

19.38 The sub-committee on insolvency proposed that if responsible persons were 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

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14 See paragraphs 19.42 to 19.47.

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. The sub-committee on insolvency preferred 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. It was felt that 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 and that it would also operate to prevent responsible persons trying to inflate the book value of assets to avoid liability for insolvent trading.

19.39 It is important in the context of a liability for insolvent trading that responsible persons should know when a company is trading while insolvent. We acknowledge that there are different ways of measuring a company's financial position and that the sub-committee on insolvency's basis of the market or realisable value of its assets in the normal course of business is reasonable.

19.40 We consider, however, that if liability is to be imposed on responsible persons the basis on which liability is established must be the basis on which directors and senior management are most accustomed to working with, which is readily capable of being understood and is referred to on a regular basis. We understand that most companies operate on a cash flow basis and can readily establish whether a company is able to discharge its liabilities as they fall due. We therefore recommend the cash flow test as the basis on which liability should be founded.

19.41 The cash flow test would have the advantage of allowing senior management to realise when a company was trading towards insolvency and to notify the directors. The directors should then act appropriately. The cash flow test of insolvent trading should also encourage companies to plan their finances in order to avoid trading while insolvent. While every company can suffer a temporary cash flow shortfall it must be able to demonstrate that it can liquidate other assets in good time to meet any known liabilities that may arise.

Responsible persons' duties

Directors' duties

19.42 We do not believe that it is possible to define comprehensively the duties of a director. For this reason we have adapted wording from the Insolvency Act[15] and the Australian Corporations Law[16] which provide broad, fact based, criteria which the courts could refine the through a body of decisions.

15 Insolvency Act, section 214.
16 Corporations Law, section 588G.

19.43 In order for a liability for insolvent trading to arise certain factual conditions would have to be established. The facts that a liquidator would need to establish are (i) that a director is or has been a director 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.

19.44 A liquidator must then consider whether a director, 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. A director would, therefore, be judged by an objective standard of the reasonable director even though he was lacking or below average in knowledge, skill or experience, but by his own standards, if, for example, his qualifications and experience were 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 are adapted from the Insolvency Act and the third limb is taken from the Australian provisions.

19.45 The third limb of the factual conditions refers to reasonable grounds for suspecting insolvency. A director 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 director in a like position in a company, in the company's circumstances, would be so aware. 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 director from claiming that he had no idea that a company might have been in danger of insolvency when the facts were such that a reasonable person would have known.

19.46 To summarise the factual conditions that would need to be established: (i) that a director knew that a company was insolvent is a self evident concept; (ii) that a director ought to have known that a company was insolvent or would so become covers the situation where a director would have known that the company was insolvent but did not, for example, attend meetings that would have acquainted him with the position of the company, and (iii) had reasonable grounds for suspecting that the company was insolvent or would become insolvent covers the situation where all the evidence was available but the director did not use his skills, or did not have the skills, to recognise that there was a problem.

19.47 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

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[17] *Re Produce Marketing Consortium Ltd (No.2)* [1989] BCLC at 550.

progression and is not usually limited to one particular debt. That is why we emphasise that directors should be able to anticipate insolvency and act before it bites. Nevertheless, there has to be a particular time when a company becomes insolvent, even though a company may move in and out of insolvency after that time.

Senior managements' duties

19.48 We have recommended that senior management should be under a duty to warn the board of directors when a company is or is about to trade while insolvent and that providing such warning is given in good time senior management would be protected from liability for insolvent trading. In determining whether warning was given in good time the same factual conditions as set out above in respect of directors would be applied to senior management.

Presumptions

19.49 We borrowed the idea of imposing presumptions from the recent Australian provisions. 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.[18] 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 and senior management as to how they should exercise their duties and responsibilities.

Presumption of continuing insolvency

19.50 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. 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.

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[18] Insolvency Act 1986, section 214(2) and (6).

19.51 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 responsible persons.

Presumption of failing to keep proper accounts

19.52 We recommend that, if it is proved that a company had, at a particular time during the 12 months ending on the date of commencement of the winding-up, contravened section 121 of the Companies Ordinance

(a) by failing to keep proper accounting records that report and explain its transactions and financial position during the 12 months before winding up, or

(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.

19.53 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.

19.54 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 of 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 recommend that it should be adopted.

19.55 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 made 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.

Defences

Directors

19.56 We consider that to provide balance to the statutory presumptions there should also be statutory defences, as is the case under the Australian provisions[19] and under the Insolvency Act.[20] The effect of an order against directors for insolvent trading could be severe. It is appropriate, therefore, to provide comfort to directors by setting out defences. To maintain a defence, a director 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.

19.57 A director should have a defence to an application against him for insolvent trading if he could 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, 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 United Kingdom 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 director acted in a bona fide manner to minimise the loss, he would be protected from an action for insolvent trading, even if his efforts proved to be unsuccessful.

19.58 For the purposes of the defence, the facts which a director 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 director in relation to the company, and the general knowledge, skill and experience that director has.[21]

19.59 In addition, we recommend that, in determining whether the defence 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 director took with a view to appointing a provisional supervisor of the company, when the action was taken, and the results of that action.

19.60 There has been criticism of the Insolvency Act provision. It has been noted that it avoids giving any concrete meaning to the concept of

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[19] Corporations Law, section 588H.
[20] Insolvency Act 1986, section 214(3).
[21] Adapted from the Insolvency Act 1986, section 214(4).

"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.[22] 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.

19.61 The recommended new provisions do not specify what action a director ought to take when a company is threatened by insolvency. We consider that directors, 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 as liability would not be collective. Resignation alone would not absolve a director from liability, but a clear record of urging that appropriate action be taken should protect a director.[23]

19.62 The dilemma that a director 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 directors 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-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 recommendation are clear: if directors did not take every step to minimise the potential loss to creditors they would face personal liability for their actions.

19.63 We recommend that, provided a liquidator can show that the company has been wound up, that it was insolvent and that the director was a director 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.

19.64 The Insolvency Act provides that the functions carried out by a director[24] 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.[25] Nonetheless, we recommend adopting the provision as omissions or inaction by directors in the context of an application for insolvent trading should not be a defence. A

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

23 See paragraph 19.28.

24 The Insolvency Act 1986 section 214(4).

25 The Annotated Guide to the Insolvency Legislation, Sealy and Milman, 4th edition at page 257.

director 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.

The Australian defences

19.65 We considered adopting the Australian defences provision which provide for four specific defences. The defences are:

(a) 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.

(b) if it is proved, without limiting the generality of (a), 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 that debt and any other debts that it incurred at that time.

(c) 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.

(d) if the person took all reasonable steps to prevent the company from incurring the debt.[26]

19.66 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 recommendations on senior management.

19.67 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

[26] See the Corporations Law, Section 588H(2) to (5).

director for insolvent trading, especially when the costs involved in making such an application are taken into account.

Senior management

19.68 A senior manager would have a defence to an application against him for insolvent trading if he could demonstrate that he had given the board of directors notice in the prescribed form that a company was trading insolvently or was about to trade insolvently.

Expenses of winding up

19.69 For the purposes of establishing whether a company was trading while insolvent or was about to trade while insolvent we recommend that responsible persons should not have to take the potential expenses involved in the winding up of a company into account. This differs from the corresponding provision under the Insolvency Act[27], 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 in any but the best advised of companies would consider the expenses of winding up when struggling to keep a company in business.

Responsible persons may be liable to compensate the company

19.70 We recommend that if the court finds a responsible person liable for insolvent trading it should be able to order the responsible person to pay compensation to the company for the benefit of the general body of creditors which would equal the general deficiency when it was wound up.

19.71 An order for payment equal to the general deficiency of a company should be made by the court when the insolvent trading had been cynical or essentially fraudulent in which case we consider it appropriate that responsible persons who are found liable should be liable for the full extent of the loss engendered by the insolvency. The court should also have a discretion to order compensation of a lesser amount in circumstances where insolvent trading was the product of, for instance, poor commercial sense or ability or was a misguided, but honest, optimism as to the chances of the business recovering. In investigating the issue of liability for insolvent trading, the court would probably gain a sufficient insight into the reasons for the company's failure to make this kind of judgment.

19.72 It is useful to clarify our thinking on the recommendation that compensation should relate to the general deficiency of the company as the

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[27] Insolvency Act 1986, section 214(6).

point may be made that the general deficiency might be much larger than the amount that was lost through insolvent trading. We take the stance, however, that although a relatively small insolvent trading debt may have been incurred, a large general deficiency may have been suffered as a result of a chain reaction triggered by the insolvency, in which case a responsible person should suffer the consequences. Providing the court with a general discretion to make a lesser award would balance any apparent harshness in the provision.

19.73 This recommendation differs from the sub-committee on insolvency's proposal which was that if the court found that a responsible person was liable for trading while insolvent, it should be able to order a responsible person to pay compensation to the company equal to the amount of that loss or such other sum as the court thought fit. We consider that this could create a danger of responsible persons avoiding full liability for insolvent trading if compensation was awarded only for the loss to the company for insolvent trading. If that was the criterion it might be argued that the company was at no loss for insolvent trading as the company was already insolvent and could not suffer further loss and in any event it might be extremely difficult in many cases to identify or link the loss directly resulting from the insolvent trading.

19.74 The provision recommended would have effect in addition to any rule or law 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.[28] [29]

Contributions by responsible persons should be compensatory

19.75 The primary purpose of the provision would be compensatory and could include the costs and expenses involved in pursuing 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[30] that the Insolvency Act wording gives the court a wide discretion in this regard.[31]

Amount of compensation individual responsible persons might have to pay

19.76 It should be left to the discretion of the court to decide the amount of compensation that should be awarded against a responsible

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28 Corporations Law, section 588P.

29 See, for instance, paragraph 19.89.

30 Knox J in *re Produce Marketing Consortium Ltd* (1989) 5 BCC at 569 at 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 Ltd* [1967] Ch. 889.

31 Insolvency Act 1986, section 214(1).

person as the actions of each responsible person would have to be judged separately. If several responsible persons in the same company 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 should have the discretion to order those responsible persons with assets to pay the full amount of the loss. It should 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 had 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.

19.77 A responsible person who had to pay a greater proportion of the compensation than other responsible persons would probably have a common law right of contribution in these circumstances. We recommend that a responsible person who paid a greater proportion of the compensation should have a statutory right of contribution from other responsible persons guilty of insolvent trading.

How recovered contributions should be applied

19.78 We have recommended that compensation recovered for insolvent trading should be paid to the company for the benefit of the general body of creditors in accordance with the existing priorities, unless the court orders otherwise.[32] We have reached this conclusion with some hesitation because it would have the effect of favouring secured creditors who would have the first bite at any compensation recovered from responsible persons. This could result in ordinary creditors receiving no benefit from the compensation, or a reduced benefit, as compensation recovered by secured creditors could release other assets which could go to the benefit of ordinary creditors after preferential creditors were paid.

19.79 We acknowledge that it could be argued that this treatment of compensation recovered goes against the spirit of the provision but we can see no justification for interfering with the established priorities in respect of charges over property of a company and for preferential payments contained in section 265 of the Companies Ordinance. If changes are to be made to these priorities they should be made in the context of an examination of the priorities in their own right rather than by using the limited effect of compensation recovered for insolvent trading to circumvent the priorities. We note that the sub-committee on insolvency will be reviewing the winding-up provisions of the Companies Ordinance, which includes preferential payments under section 265, in its final report to the Commission.

32 See paragraphs 19.70 and 19.71.

19.80 Our recommendation differs from the approaches taken by both the Australian Corporations Law and the Insolvency Act. The Harmer Report recommended that an amount recovered in an action for breach of duty be available for distribution only among unsecured creditors because insolvent trading would have its major impact upon them.[33] The Australian Corporations Law now provides that compensation paid for insolvent trading should not be available to pay a secured debt of a company unless all the company's unsecured debts have been paid in full.[34]

19.81 The Cork Report[35] 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 1986. 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.[36]

19.82 A complicating issue is 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.

19.83 We therefore recommend that where a creditor or creditors knew that a 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.

Funding of application or indemnity by creditors

19.84 A further issue concerns the funding of an application by a creditor which resulted 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 recommend that any creditor or creditors who indemnify an application by the liquidator should be entitled to receive an additional payment that reflected the risk run in providing the indemnity. We note that the Companies Ordinance[37] 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

33 Harmer Report, paragraphs 320 and 321.
34 Corporations Law, section 588Y(1).
35 The Cork Report, paragraph 1797 and 1806(4).
36 Hicks, The Company Lawyer, Vol. 14, No.1 at page 19. See also the Annotated Guide to the Insolvency Legislation, Sealy and Milman 4th edition at page 255.
37 The Companies Ordinance, section 265(5B).

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.

19.85 The position was recently considered in the High Court in Hong Kong in a case[38] 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:

(a) encouragement should be given to those willing to assist liquidators in recovery of assets;

(b) 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;

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

19.86 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 recommend, however, that an order to pay compensation in respect of insolvent trading should be enforceable as if it were a judgment of the court.

Creditors should not be able to make an application in respect of insolvent trading

19.87 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.[39]

Assignment of application

19.88 A liquidator has the power under the Companies Ordinance to assign the right of action to a creditor or other party.[40] In the case of insolvent

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38 *In re Intertrans Far East Ltd.* [1994] 2 HKC 704.

39 See sections 199 and 200 of the Companies Ordinance.

40 Companies Ordinance, section 199.

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 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

19.89 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 IVA of the Companies Ordinance. The recommendation follows a parallel provision in respect of disqualification for fraudulent trading under section 168L of Part IVA 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

19.90 We recommend that if a person acted as a director of a company which went into insolvent liquidation at a time when he was disqualified as a director under Part IVA of the Companies Ordinance, he may be held liable for the debts of the company.

Transitional

19.91 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.

Holding companies

19.92 The sub-committee on insolvency proposed that holding companies should be open to liability for the insolvent trading of a subsidiary company. The sub-committee, however, had taken the view that it was neither appropriate nor practical to propose the introduction of a provision to make holding companies liable for the insolvent trading of a subsidiary on the basis that any provision which sought to lift the corporate veil should be considered in the overall context of Hong Kong's company law and not in isolation.

19.93 The sub-committee noted in the Consultation Paper that new provisions had been introduced in Australia on the issue and asked for comment on the introduction of a provision equivalent to the Australian provision.

19.94 The sub-committee received three submissions in response, all of which considered that holding companies should be capable of being liable for insolvent trading. The Inland Revenue Department submitted that many cases of insolvency were caused by the transfer of business or assets to related companies, the distribution of profits or the channelling of funds to holding companies. The Department's view was that where this had occurred, a holding company involved in such dealings should be made liable to pay back the funds so distributed or transferred.

19.95 The Hong Kong Society of Accountants submitted that a holding company could be brought into the proposed legislation within the concept of the shadow director and did not understand why a distinction was being made between a holding company as a shareholder and any other individual shareholder. The Hong Kong Association of Banks supported the introduction of the Australian provisions, seeing no difference between making a holding company liable and making a director liable, as in both events, the corporate veil was lifted.

19.96 The sub-committee was persuaded by the force of the arguments received that the Australian provisions should be adopted, making holding companies open to liability for insolvent trading. The sub-committee noted, however, that members of the sub-committee were divided in their views on the provision. Questions were raised whether it would be right to lift the veil on inter company relationships under any circumstances. There was, however, some support for the idea that the corporate veil should be lifted in the limited context of insolvent trading and that holding companies should be liable for insolvent trading of subsidiaries.

19.97 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 were 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 supported their fellow companies rather than jeopardise the reputation and credit rating of the entire group.

19.98 The sub-committee harboured doubts about its own proposal and noted it was divided on the issue. The same can be said for the Commission. The matter was fully aired without the Commission being able to reach any conclusion. We have no settled view as to whether liability for insolvent trading should be extended to holding companies but we consider that it is worthwhile to record the major exchanges of view expressed. We would note that notwithstanding that no direct recommendation is being made a holding company could still be held liable for insolvent trading as a shadow director.

The new Australian provisions

19.99 The new Australian law on a director's duty to prevent insolvent trading by a company which inspired the debate contains a provision[41] 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 nature 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."* [42]

19.100 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.[43]

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41 Corporations Law, section 588V.

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

43 Corporations Law, section 588X.

The arguments relating to making holding companies liable for insolvent trading

19.101 While arguments made on the legal ground that applying the insolvent trading provisions to holding companies would represent a significant attack on the principle of separate corporate identity there was a strong sentiment that it would be satisfying to strike a blow against those who hid behind corporations while still exercising control over subsidiary or subordinate companies. This view was tempered by the knowledge that inter related corporate structures are an aid to commerce in general and that most groups of companies are well run and should not suffer as a consequence of the behaviour of rogue operators.

19.102 The point was made that a holding company was in principle merely a company which was the owner, for instance, of all or a majority of the shares of another company, its subsidiary. This would not of itself imply that the holding company or the directors of the holding company would take any part in the direction of the subsidiary's day to day affairs. A subsidiary could well have a different board of directors, its own minority shareholders and its own set of creditors. Its interests may, on particular issues or in particular transactions, be quite different from those of other companies in its group. The argument was made that it was a legitimate social policy to permit trading in organised groups of companies, each with its own separate personality and limited liability.

19.103 If a subsidiary failed and left debts it would not follow that the holding company was guilty of wrongdoing in not rescuing the subsidiary or that the holding company was involved in insolvent trading.

19.104 The law recognises the independence of companies within a group and between holding company and subsidiary. It is established that the duty of the directors of a subsidiary in a group of companies is to act in the best interests of the subsidiary and not of the group.[44] A parent company cannot compel the directors of a subsidiary to conduct that subsidiary's business in a manner that would take into account the group's interests.[45]

19.105 Plainly, where a holding company runs the affairs of the subsidiary which is an otherwise lifeless shell, then the holding company should be treated as a shadow director and made liable for insolvent trading. Where, however, there are groups of companies with active subsidiaries pursuing bona fide different commercial ventures some of which may fail on insolvency, no policy justification exists for treating the holding company as a shadow director without more. To do so would be to inhibit legitimate group activities and would be likely to prove unacceptable to the business

[44] *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1959] 2 All E.R. 1185 at 1194; *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch. 246; Schmittoff and Wooldridge, Groups of Companies (Sweet and Maxwell, 1991) pages 2 and 59 to 62, 66.

[45] *Pergamon Press Ltd v Maxwell* [1970] 1 WLR 1167; Palmer's Company Law, paragraph 8.508.

community. It could lead to companies being forced into guaranteeing the solvency of every subsidiary, destroying the benefits of separate corporate identities and limited liability.

19.106 Consideration was given to providing that a company would be deemed to be a subsidiary of another company under the definition of subsidiary company in section 2(4)(5)(6) of the Companies Ordinance for the purposes of an insolvent trading provision. The section provides that:

> *"(4) For the purposes of this Ordinance, a company shall, subject to the provisions of subsection (6), be deemed to be a subsidiary of another company, if -*
>
> *(a) that other company -*
> *(i) controls the composition of the board of directors of the first-mentioned company; or*
> *(ii) controls more than half of the voting power of the first-mentioned company; or*
> *(iii) holds more than half of the issued share capital of the first-mentioned company (excluding any part of it which carries no right to participate beyond a specified amount in a distribution of either profits or capital); or*
>
> *(b) the first-mentioned company is a subsidiary of any company which is that other company's subsidiary.*
>
> *(5) For the purposes of subsection (4), the composition of a company's board of directors shall be deemed to be controlled by another company if that other company by the exercise of some power exercisable by it, without the consent or concurrence of any other person, can appoint or remove all or a majority of the directors, and, for the purposes of this provision, that other company shall be deemed to have power to make such an appointment if -*
>
> *(a) a person cannot be appointed as a director without the exercise in his favour by that other company of such a power; or*
>
> *(b) a person's appointment as a director follows necessarily from his being a director or other officer of that other company.*
>
> *(6) In determining whether one company is a subsidiary of another company -*
>
> *(a) any shares held or power exercisable by that other company in a fiduciary capacity shall be treated as*

not held or exercisable by it;

(b) *subject to paragraphs (c) and (d), any shares held or power exercisable -*

(i) *by any person as a nominee for that other company (except where that other company is concerned only in a fiduciary capacity); or*

(ii) *by, or by a nominee for, a subsidiary of that other company, not being a subsidiary which is concerned only in a fiduciary capacity,*

shall be treated as held or exercisable by that other company;

(c) *any shares held or power exercisable by any person by virtue of the provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded; and*

(d) *any shares held or power exercisable by, or by a nominee for, that other company or its subsidiary (not being held or exercisable as mentioned in paragraph (c)) shall be treated as not held or exercisable by that other company if the ordinary business of that other company or its subsidiary, as the case may be, includes the lending of money and the shares are held or power is exercisable as aforesaid by way of security only for the purposes of a transaction entered into in the ordinary course of that business."*

19.107 It was felt, however, that to provide that a company could be liable for insolvent trading if it held more that half of the issued share capital of another company, as would be the case if section 2(4)(a)(iii) was applied, would be a very low trigger on which to ground liability for insolvent trading. Moreover, the issue of control of the board of directors under section 2(4)(a)(i) is affected by our recommendations on shadow directors.[46]

19.108 It was pointed out and accepted that in the majority of cases if the person who controlled the company was a holding company it could be caught as a shadow director under our recommendations on shadow directors. For this reason it might be appropriate to draw the line at liability for shadow directors.

[46] See paragraphs 19.19 to 19.23.

19.109 There might also be an additional danger in imposing liability on holding companies which could have far reaching consequences on how business is done. In the event that a subsidiary company was wound up with outstanding debts, holding companies could become an attractive target for creditors looking for someone with deep pockets to sue and there could be a risk that holding companies would be sued for that reason alone.

19.110 Strong views were, however, expressed that notwithstanding the arguments which pointed out that imposing liability on holding companies would be contrary to current legal principles, holding companies should be open to liability if they failed the tests which would be applied to any director or senior manager of a company. It was felt that there were many instances where groups of companies were formed with the intention of removing those who actually controlled a company from appearing to do so and that there was justification for treating all holding companies as shadow directors as, ultimately, it was holding companies which pulled the strings of subsidiaries.

19.111 If the tests that would be applied to responsible persons were applied to a holding company a liquidator would have to prove that a holding company knew that a subsidiary was insolvent, ought to have known that a subsidiary was insolvent or would so become, or had reasonable grounds for suspecting that a subsidiary was insolvent or would become insolvent, and failed to prevent the subsidiary from incurring the relevant debts. The presumptions and defences outlined above would also apply to holding companies. It was argued that this was a desirable provision that would enable liquidators to look behind the veil of corporate identity to find the ultimate controller of a company and, if appropriate, to hold the controller responsible.

19.112 It was suggested that it would be harsh to impose liability on holding companies as the day to day running of a subsidiary company could legitimately go on without direct input from the directors of the holding company. As referred to above, there are cases which indicate that directors of subsidiary companies have a duty only to act in the best interests of the subsidiary and not of the group and that parent companies cannot compel directors of subsidiaries to conduct the business in a manner taking into account the group's interests. Under such circumstances, to provide that holding companies could be held liable for insolvent trading by a subsidiary, even with the defences that would be available, could force groups of companies to change their business practices. It would be preferable therefore that if insolvent trading was to be applied to holding companies it should only be applied under a general review of the law relating to holding companies and their subsidiaries.

19.113 Finally, we note that as of March 1996, 341 companies listed on the Stock Exchange of Hong Kong were companies incorporated outside Hong Kong registered under Part XI of the Companies Ordinance. The total number of listed companies was 544.[47] Any attempt to lift the veil on those

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[47] As of 22nd March 1996. Source: The Stock Exchange of Hong Kong.

companies incorporated in other jurisdictions would have extra-territorial implications.

Fraudulent trading under section 275 of the Companies Ordinance

19.114 The insolvent trading recommendations, 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.[48]

19.115 There are two main reasons for preserving fraudulent trading for now, but we will consider the provision further in our final report on the winding up provisions of the Companies Ordinance. First, fraudulent trading contains both a criminal[49] 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.

19.116 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.[50] The plaintiff must prove that:

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

(b) 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.

(c) If (a) and (b) are shown by the facts, then fraud or dishonesty could be established by inference, subject to

(d) 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

(e) 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.

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48 Insolvency Act 1986, section 213.

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

50 *Aktieselskabet Dansk Skibsfinansierung v Wheelock Marden & Co. Ltd.* [1989] 2 HKC 273.

Annexure I

List of Organisations in Hong Kong which commented on the Consultation Paper

Chinese Gold & Silver Exchange Society

Chinese University of Hong Kong

Companies Registry

Education and Manpower Branch

Federation of Hong Kong and Kowloon Labour Unions

Government Supplies Department

Hong Kong Association of Banks

Hong Kong Bar Association

Hong Kong Coalition of Service Industries

Hong Kong Democratic Foundation

Hong Kong Exporters' Association

Hong Kong Federation of Insurers

Hong Kong Institute of Company Secretaries

Hong Kong Management Association

Hong Kong Monetary Authority

Hong Kong Productivity Council

Hong Kong Shipowners Association Ltd

Hong Kong Society of Accountants

Hong Kong Tourist Association

Housing Department

Inland Revenue Department

Labour Department

Law Society of Hong Kong

Legal Aid Department

Nelson Wheeler Corporate Reconstruction and Insolvency Limited

Office of the Commissioner of Insurance

Retail Management Association Limited

Royal Hong Kong Police

Securities & Futures Commission

Trade and Industry Branch