THE LAW REFORM COMMISSION OF HONG KONG

REPORT ON

THE WINDING-UP PROVISIONS OF THE COMPANIES ORDINANCE

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This report can be found on the Internet at: **_<http://www.info.gov.hk>_**.

Mr Jeremy Glen*, Senior Government Counsel, was principally responsible for the writing of this Commission report.*

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 Secretary for Justice or the Chief Justice.

The members of the Commission at present are:

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Introduction

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

Terms of reference

2. On 14th September 1990, the then 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 then Attorney General to consider the reference and report to the Commission. The Insolvency Sub-committee is chaired by Professor Edward L. G. Tyler, formerly a Judge of the District Court and Professor and Head of the Department of Professional Legal Education at the University of Hong Kong, and now Professor of Law of the School of Law 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 Insolvency Sub-committee are:

Mr Mark Bradley	**Solicitor,**

	Deacons Graham and James
Mr Graham Cheng OBE JP	**Chairman, Taching Petroleum Company Limited**
Mr S. K. Cheung (since 7.8.1995)	**Senior Executive, Commercial Banking, Hong Kong and Shanghai Banking Corporation Limited**
Mr Nicholas Etches	**Accountant, KPMG Peat Marwick**
Mr Stefan Gannon JP	**General Counsel, Hong Kong Monetary Authority**
Mr David Hague	**Accountant, PricewaterhouseCoopers**
Mr Robin Hearder JP	**The former Official Receiver**
Mr Nic Johnston (since 7.8.1995)	**Solicitor, Freshfields**
Mr Winston Poon SC	**Barrister**
Mr Ian Robinson	**Accountant, formerly of Ernst & Young, now a director of Robinson Management Limited**
Mr Jeremy Glen	**Senior Government Counsel (Secretary)**

4. The terms of reference provided that the Commission could make an interim report on such other aspects of insolvency law or practice which the Commission considered should be introduced in advance of the final report on insolvency. The Insolvency 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 on Bankruptcy* to the Commission, the Insolvency 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 and to impose liability on directors and senior management for trading while a company was insolvent. The Insolvency Sub-committee's report to the Commission formed the basis of the Commission's *Report on Corporate Rescue and Insolvent Trading* which was published in October 1996.

The consultation process

6. The winding-up provisions of the Companies Ordinance (Cap. 32), when taken in conjunction with the provisions on receivership and the winding-up of unregistered companies under Part X of the Companies Ordinance, account for about 165 of over 360 sections in the Ordinance. These sections are supported by subsidiary legislation in the form of the Companies (Winding-up) Rules.

7. The *Consultation Paper on the Winding-up Provisions of the Companies Ordinance* was published by the Insolvency Sub-committee in April 1998. The Insolvency Sub-committee considered that in order for the *Consultation Paper* to be as comprehensive as possible it would be necessary to seek preliminary submissions from interested bodies on the winding-up provisions before the *Consultation Paper* was published. The responses received were reflected in the *Consultation Paper*.

8. The *Consultation Paper* was sent to about 330 consultees and was also made available free of charge to other interested parties. The Insolvency Sub-committee received about 60 responses to the *Consultation Paper*, with about 40 of these containing substantive comment.

9. Where a section is not mentioned in the report it is because the Insolvency Sub-committee has no comment to make on it.

Confidentiality

10. This report introduced submissions into the text without quotation for the purposes of making the report "flow" and submissions were only placed in quotations where the quote was substantial or where the body was a Government / representative body where it was appropriate to identify the maker of the submission. Examples of this may be found in the report at Chapter 20 where the Protection of Wages on Insolvency Fund Board, the Commissioner of Inland Revenue and the Secretary for Financial Services addressed issues relating to their own fields of interest.

11. None of those who made submissions to the *Consultation Paper* requested confidentiality. A list of submissions on the *Consultation Paper* is annexed.[1] The Commission would like to express its gratitude to all those who made submissions.

Abbreviations and other expressions used in this report

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:

[1] See Annex.

“*The Commission*” : This refers to the Law Reform Commission of Hong Kong.

“*Consultation Paper*” : This refers to the *Consultation Paper of the Winding-up Provisions of the Companies Ordinance* published by the Insolvency Sub-committee in April 1998.

“*The Cork Report*” : *The Report of the United Kingdom Committee on Insolvency Law and Practice* under the Chairmanship of Sir Kenneth Cork.[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.

“*The court*” : References are made throughout the report to the court or the Hong Kong court. All winding-up and bankruptcy cases are heard in the Court of First Instance of the High Court of the Hong Kong Special Administrative Region, which was known as the High Court before July 1997.

“*Office-holders*” : See Chapter 4. Office-holder is a loosely defined expression which encompasses liquidators, provisional liquidators, receivers, trustees in bankruptcy and provisional supervisors (when introduced).

“*Provisional supervision / Provisional supervisor*” : These expressions refer to initiatives recommended by the Commission in its *Report on Corporate Rescue and Insolvent Trading* published in October 1996.

Report in English and Chinese

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

[2] 1982. Cmnd 8558.

Chapter 1 - Overview

1.1 The function of the insolvency provisions of the Companies Ordinance is to provide a means by which companies which fail can be disposed of effectively or restructured. At its crudest, the insolvency provisions may be considered to be the waste disposal system for companies which have failed and while this is undoubtedly the case with the majority of companies which become involved in insolvency processes, it is not the full story.

1.2 There is a need for the insolvency provisions because, although the vast majority of companies do not become insolvent, those that do leave behind a trail that needs to be tidied up, a point that we address further in the chapter on the funding of the Official Receiver's Office.[3] This is an important function, as it oversees the fair distribution of the remaining assets of the insolvent company among its creditors. This is not to say that the administration of an insolvent company is simple matter. It can be difficult to recover assets, particularly in situations where companies do not have the cash to fund recovery actions, and there are often difficulties in getting the former owners to co-operate with each other and with the liquidator.

1.3 The insolvency provisions are only necessary because the nature of doing business requires that companies operate on credit: companies borrow money in order to trade and develop. This process is not limited to companies; private individuals and countries also go into debt. The types of debt that are now being developed in the financial markets are tending to increase the complexity of some insolvencies, usually those where the insolvent company is a finance company or bank or where a company is dealing in complex debt market contracts. The more usual forms of debt used by companies involve the obtaining of loans from financial institutions or the obtaining of credit terms from companies with which a company is doing business.

1.4 The impact of the failure of a company that has been carrying on a genuine business is difficult to understand at first glance. The obvious victims are the employees and the shareholders of the company but the failure also affects unpaid creditors and the holders of loans that might have been made to the company. When, as happens periodically, significant numbers of companies fail at about the same time, the impact on an economy becomes plain and can be seen in the form of increased unemployment, falling prices, poorer results from companies which are still in business and increasing social discontent.

1.5 The law of insolvency cannot prevent economic downturns but it can assist in ameliorating the effect of the downturn. The aim of this report is to examine the existing company winding-up provisions and to see how they can be improved or developed to facilitate the more efficient winding-up of companies. The Australian Law Reform Commission' s *General Insolvency Inquiry*, better known as the *Harmer Report*, identified certain principles that should guide the development of a modern insolvency law.[4] We cannot express those principles in any better way and therefore

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[3] See paragraphs 5.8 to 5.21.

[4] *General Insolvency Inquiry*: a Report of the Law Reform Commission of Australia under the Chairmanship of Mr Ron Harmer, paragraph 33.

set them out below. These principles apply equally well to this report as it did to the *Harmer Report*. We would note that the *Harmer Report* addressed both individual and corporate insolvency. The Commission' s *Reports on Bankruptcy and Corporate Rescue and Insolvent Trading*, when read with this report, would cover all the principles identified in the *Harmer Report*, which are that:

> *"(a) the fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies;*
>
> *(b) insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense;*
>
> *(c) an insolvency administration should be impartial, efficient and expeditious;*
>
> *(d) the law should provide a convenient means of collecting or recovering property that should be applied toward payment of the debts and liabilities of the insolvent person;*
>
> *(e) the principle of equal sharing between creditors should be retained and in some areas reinforced;*
>
> *(f) the end result of an insolvency administration, particularly as it affects individuals, should, with very limited exceptions, be the effective release or relief from the financial liabilities and obligations of the insolvent;*
>
> *(g) insolvency law should, so far as it is convenient and practical, support the commercial and economic processes of the community;*
>
> *(h) as far as is possible and practical, insolvency law should harmonise with the general law; and*
>
> *(i) an insolvency law should enable ancillary assistance in the administration of an insolvency originating in a foreign country."*

1.6 It is when companies, individuals and countries do not manage their debt properly or take on unsustainable amounts of debt, either because of indiscipline, incompetence or dishonesty, or they are struck by situations that could not have reasonably been predicted, that the insolvency provisions are called upon to tidy up the resulting mess.

1.7 The last two years have produced some graphic examples of companies, individuals and countries moving from positions that were perceived as being solvent, secure and solid, to positions of penury. This happened so suddenly that it took nearly everybody, including those whom might have been expected to have known better, by surprise. Bad management and dishonesty have undoubtedly had their place in the current crisis. The bad luck can be found in the cases of companies and individuals who took positions that at the time seemed to be appropriate but falling currencies and failing markets have driven to the wall those who would otherwise still be doing good business.

1.8 While the imposition of good business practice is more the function of the main companies provisions, the insolvency provisions hold scope for creativity in dealing with companies which are heading towards insolvency but which still have potential. In the *Report on Corporate Rescue and Insolvent Trading,* we have recommended the adoption of a corporate rescue procedure based on procedures that are already operating successfully in other jurisdictions and the recently[5] amended bankruptcy provisions have introduced a scheme which would assist individuals with debt problems to reorganise them under the protection of the court.

1.9 Outside of the bare insolvency provisions, the nature of insolvency is undergoing changes in that there are now many more significant insolvencies that cannot be dealt with simply on a local basis. These international insolvencies can take on a complexity that is virtually unfathomable, particularly where those who control the insolvent entity are not acting in the best interests of company or its creditors. There is no need to name names but over the last several years there have been many jurisdictions that have suffered from well known business people being found to have gone on a frolic of their own with company assets.

1.10 The recommendations we made in this report extend from, frankly, recommendations for dull technical amendments, to recommendations that would constitute a significant shift in the way the insolvency provisions are administered. The purpose, therefore, of this report, is to reposition the insolvency provisions so that they will be better able to deal with changes in the business, legal and social environment.

Review of the Hong Kong Companies Ordinance

1.11 In addition to this report on the winding-up provisions of the Companies Ordinance, a *Consultancy Report on the Review of the Hong Kong Companies Ordinance*, on the other provisions of the Companies Ordinance, was published in 1997.

1.12 The *Review of the Hong Kong Companies Ordinance* recommended that the insolvency provisions of the Companies Ordinance should be separated from what it describes as the "*core*" provisions of the Companies Ordinance, which the *Review* recommends should not have extraterritorial effect.[6] The recommendations under Part X of the Companies Ordinance on cross-border insolvency would give the insolvency provisions extraterritorial effect.

Recommendations / Format of the report

1.13 The opening chapters of the report address a number of issues relevant to the law of insolvency in general. These issues, that is, recommendations for a separate Insolvency Ordinance[7], the licensing of insolvency practitioners, the remuneration of office-holders, and the funding of the Official Receiver's Office, are contained in Chapters 2 to 6. These issues are best addressed first as the

5 Bankruptcy (Amendment) Ordinance 1996, which came into effect on 1 April 1998.

6 *Review of the Hong Kong Companies Ordinance,* paragraphs 1.01 and 1.05, and see also Chapter 26 of this report.

7 Note that the reference to "*Insolvency Ordinance*" is made for convenience only and is not intended as a recommendation for the title to any new Ordinance. A more comprehensive title might be more appropriate.

comments and recommendations made under these chapters have a bearing on other recommendations made in relation to the provisions of the Companies Ordinance that follow.

Language of the new Insolvency Ordinance

1.14 Assuming that these recommendations are ultimately adopted, we note that the language of many of the provisions recommended (for instance, those from the Insolvency Act) would be expressed in a language different from many of the current provisions of the Companies Ordinance and Bankruptcy Ordinance (Cap. 6).

1.15 It would be desirable for the provisions of any new Insolvency Ordinance to be expressed in the same terms throughout and we **recommend** that, in drafting a new Insolvency Ordinance, the opportunity should be taken to review those provisions on which we make no comment with a view to expressing the new Ordinance in modern language.

1.16 We **recommend** that a new Ordinance should be set out in such a way as to avoid the long sub-sections that proliferate in the current provisions. We have noticed that identical provisions in the Insolvency Act have been broken down into smaller sub-sections that are more readily understandable.

1.17 We **recommend** that sub-sections should be titled, as is the practice in the Insolvency Act. We realise that this is not the convention in the Ordinances of Hong Kong but the practice is an aid to understanding and finding provisions and should be adopted.

Chapter 2 - A Separate Insolvency Ordinance to Include All Forms of Winding-up, Receivership, Provisional Supervision and Bankruptcy

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2.1 The *Consultation Paper* proposed that there should be a separate Insolvency Ordinance which would contain all matters relevant to insolvency, including bankruptcy.

2.2 The *Review of the Hong Kong Companies Ordinance* recommended that a new Companies Ordinance should only contain what it described as "*core*" company matters.[8] This would not include the insolvency provisions, which the *Review* recommended should be left to a comprehensive Insolvency Ordinance.[9] The *Review* further recommended that only solvent dissolution and liquidation should be dealt with in the new Companies Ordinance.[10] In effect, this would mean that a new Insolvency Ordinance would not provide for members' (solvent) voluntary winding-up, a point with which we disagree. We are, however, broadly in agreement with the *Review*'s approach.

2.3 The *Consultation Paper* proposals received broad support in a number of submissions and we **recommend** that all insolvency matters should be placed in an Insolvency Ordinance. These would include winding-up by the court, creditors' (insolvent) voluntary winding-up, members' (solvent) voluntary winding-up and bankruptcy. There are, however, areas of dispute.

2.4 On a practical level, we anticipate that a process which would involve the introduction into legislation of amendments to the Companies Ordinance as a consequence of this report at the same time as an exercise to establish an Insolvency Ordinance would result in delays in the introduction of amendments to the Companies Ordinance. We therefore **recommend** that the amendments are made to the winding-up provisions of the Companies Ordinance first and that the establishment of an Insolvency Ordinance should be undertaken as a separate exercise.

Receivership and provisional supervision

2.5 In the broader, corporate, context of a new Insolvency Ordinance, we **recommend** that the current provisions of the Companies Ordinance on receivership and the proposed provisions on provisional supervision should be included in any new Insolvency Ordinance. There has been no disagreement on this point but we refer to these processes specifically because a company that goes into receivership or provisional supervision is not necessarily insolvent. It seems logical, however, to

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[8] Paragraph 1.01 of the *Review*.
[9] Paragraph 1.05 of the *Review*.
[10] Part 9.00 of the *Review*. See, in particular, paragraph 9.01.

include these provisions in an Insolvency Ordinance. The Insolvency Act contains provisions on receivership, bankruptcy, winding-up, voluntary arrangements and administration of companies.

Members' (solvent) voluntary winding-up

2.6 The *Consultation Paper* expressed uncertainty as to whether the provisions on members' (solvent) voluntary winding-up should be contained in the Insolvency Ordinance as members' (solvent) voluntary winding-up involved the winding-up of solvent companies. On balance, however, we **recommend** that the provisions on members' (solvent) voluntary winding-up should be included in an Insolvency Ordinance as the procedures involved in members' (solvent) voluntary winding-up are the same as for other forms of winding-up and because it would be more convenient for insolvency practitioners dealing with all forms of winding-up to find the winding-up provisions in one Ordinance.

2.7 We note that members' (solvent) voluntary winding-up should not be confused with those provisions that the Registrar of Companies is preparing for a simplified procedure for the dissolution of companies. This procedure might be more properly placed in the Companies Ordinance.[11]

Disqualification of directors

2.8 The *Consultation Paper* proposed that, as the provisions of Part IVA of the Companies Ordinance on disqualification of directors were closely related to the insolvency regime, it should be included in any new Insolvency Ordinance. The *Review of the Hong Kong Companies Ordinance* recommended that the disqualification provisions should be eliminated from the core Companies Ordinance provisions.[12]

2.9 The Registrar of Companies submitted that he had some difficulty with the proposal that Part IVA should be transferred to a new Insolvency Ordinance. The Registrar said that in company law, the directors of a company occupied fundamentally important positions and, conceptually, it would be difficult to separate the provisions regarding their disqualification from the other provisions governing their appointment, behaviour and resignation as directors. The Registrar submitted that, furthermore, sections 168D to 168T should, in any event, remain in the Companies Ordinance given that their effect and reach was equally applicable to the directors of solvent companies.

2.10 We are inclined to accept the Registrar' s point as directors of solvent and functioning companies should be able to refer to the Companies Ordinance to find out their obligations. We accept that the provisions could get hidden if placed in an Insolvency Ordinance.

Procedures should be kept separate within an Insolvency Ordinance

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11 See paragraphs 17.25 to 17.31.

12 *Review of the Hong Kong Companies Ordinance*, paragraph 6.18.

2.11 The *Consultation Paper* proposed generally that provisions that were common to different forms of winding-up should be combined in a single section that would apply to more than one form of winding-up. There are many instances of this happening, particularly in relation to creditors' (insolvent) voluntary winding-up and members' (solvent) voluntary winding-up.

2.12 Experience has shown us, however, that while this may make for a shorter Ordinance, it also leads to confusion and we have found that many provisions which on the face of it would fit more than one form of winding-up do not quite fit, and this can lead to problems. We therefore **recommend** that provisions should be kept separate. The Insolvency Act provides a good example of the sort of Ordinance that we would like see as it has the various forms of insolvency neatly divided into parts.

Chapter 3 - Licensing of Insolvency Practitioners

3.1 These recommendations for the licensing of insolvency practitioners would constitute a major change to the practice of insolvency in Hong Kong. The numerous references made in this report to licensing in relation to other issues bear out the impact that licensing would have on the winding-up provisions of the Companies Ordinance and on the practice of insolvency in Hong Kong.

3.2 We would note that since the *Consultation Paper* there have been a number of developments in relation to approach of the court to insolvency practitioners. This chapter should therefore be considered in conjunction with the chapter on the remuneration of insolvency practitioners as we received a number of submissions which expressed reservations about the dangers of a closed shop.[13] One submission summed up the reservations as follows:

> "*There is ... concern that licensing might enable fees to be maintained at a high level, which is not in the interests of anyone except licensed practitioners. As the majority of liquidations and receiverships are properly conducted, the need for a new regime of licensing and regulations and the expenses which this will entail have to be carefully considered.... Creditors should be free to appoint a person whom they consider to be suitable.*"

3.3 We suggest that the concerns expressed are adequately covered as a system of licensing would increase transparency and the Panel recommended in the chapter on the remuneration of insolvency practitioners would also serve as a check on the escalation of costs. We also note the Registrar of Companies' proposal for the establishment of a simplified method for the dissolution of companies.[14]

3.4 In 1996, the Official Receiver established and now manages two "*Administrative Panels of Insolvency Practitioners for the Court Winding-up of Companies*". The "*Administrative Panels*" are based on similar regulatory provisions that have been established in the United Kingdom and Australia and these recommendations are based on those provisions.[15]

3.5 The Administrative Panels originally consisted of member firms of the Hong Kong Society of Accountants which were deemed to possess the necessary expertise and resources to be appointed as special managers or liquidators of companies wound-up by the court having estimated realisable assets of more than $200,000 after deduction of the Official Receiver's fees for acting as the provisional liquidator.

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[13] See Chapter 4.

[14] See paragraph 17.25 to 17.31.

[15] See the Insolvency Act, sections 387 to 398, and the Insolvency Practitioners Regulations under Statutory Instruments Numbers 1995 of 1986 and 439 of 1990 in respect of England and Wales.

3.6 All cases with realisable assets of more than $200,000 are considered to be "*non-summary*" whereas cases which are defined as "*summary*" cases under section 227F were, until recently, wound-up by the Official Receiver as liquidator in a summary manner.[16]

3.7 The Official Receiver has now expanded the contracting out scheme to summary cases by the establishment of a second panel of practitioners to act as special managers in summary cases, with the Official Receiver remaining as liquidator and in overall control of a summary liquidation. The two panels are now known as the "*List A Panel*" and the "*List B Panel*". There are about 15 firms licensed under the contracting out scheme on each of the List A Panel and the List B Panel and about 18 firms overall.

3.8 The Official Receiver makes appointments from the List A Panel on a roster basis if the statutory meeting of creditors does not appoint a liquidator of its choice. Appointments from the List B Panel are also made on a roster basis.

3.9 The main criteria for membership of the List A Panel are that members must have at least four professional accountants who are members of the Hong Kong Society of Accountants, and two of those accountants must be recognised by the Official Receiver as insolvency professionals with a minimum number of 600 chargeable hours in the last three years or 750 chargeable hours in the last five years of relevant insolvency work, which excludes members' (solvent) voluntary windings-up, in addition to other requirements. The requirements for the List B Panel are a reduced number of qualifying hours in creditors' (insolvent) voluntary windings-up, compulsory windings-up or in receiverships, with some qualifying hours in members' (solvent) voluntary winding-up work, among other requirements.

3.10 These additional requirements include undertaking to accept any cases allocated by the Official Receiver, unless there are good reasons which preclude a member from taking an appointment, the carrying out of a minimum standard of statutory investigation, and to continue to handle a case until its reasonable conclusion. Remuneration of liquidators and special managers appointed from the Panels is set down in scales of fees which are reviewed annually by the Official Receiver.[17]

3.11 The winding-up of companies and other insolvency related appointments require high standards of liquidators and other insolvency practitioners as it is they who are charged with realising, managing or re-organising assets and with distributing assets to those entitled to them.

3.12 There has been anecdotal evidence of abuse where assets in windings-up have been diverted by unscrupulous liquidators, usually by selling the assets at low prices to persons connected with the directors. In addition, there has also been some evidence over the last several years of receivers and liquidators being appointed who have had only a vague idea of their functions and obligations.

3.13 We consider that although the majority of liquidations and receiverships are properly conducted, there is a need to regulate appointments to act in insolvency or insolvency related matters and we **recommend** the introduction of a new two tier system of licensing of insolvency practitioners to be established and

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[16] See section 227F, paragraphs 14.116 to 14.119.

[17] Note also the comments on remuneration in Chapter 4.

operated by the Official Receiver: "*Licensed Insolvency Practitioners*" who would act in all forms of liquidation, receivership, provisional supervision and bankruptcy and "*Registered Insolvency Practitioners*" who would act in members' (solvent) voluntary winding-up, creditors' (insolvent) voluntary winding-up and individual voluntary arrangements in bankruptcy.[18] The establishment of a system of licensing would have the effect of enhancing the power of insolvency practitioners and reducing the potential for abuse. In a climate where the court has expressed scepticism as to bills of costs presented by partners of the largest accounting firms in the world, it is logical to conclude that there is a need to introduce greater regulation of appointments of all office-holders.

3.14 Appointments to the new Administrative Panel would be made by the Official Receiver, based on the qualifying criteria for appointments under the current Administrative Panels. In addition to the current situation where only accountants can be appointed to the List A Panel, members of the Law Society and any additional categories of persons with the requisite experience would be entitled to apply to the Official Receiver to be licensed to act as Licensed Insolvency Practitioners or Registered Insolvency Practitioners. In addition, members of the Hong Kong Institute of Company Secretaries would be entitled to be appointed as Registered Insolvency Practitioners once they have fulfilled the qualifying criteria set down for Registered Insolvency Practitioners.

3.15 In calculating the number of hours for qualification as Licensed and Registered Insolvency Practitioners, we suggest that the criteria should be broadly based on the criteria applied to the current requirements for appointment under the existing Administrative Panels.

3.16 The ultimate aim, however, would be to introduce professional insolvency practitioner qualifications based on examinations that would be established by the Official Receiver and the relevant bodies at a later date.

3.17 The licensing system should be tiered so that the most difficult forms of insolvency work should be carried out by those best qualified to do it, that is, by Licensed Insolvency Practitioners. In saying this, we recognise that some members' (solvent) voluntary winding-up cases and summary compulsory winding-up cases produce difficulties and challenges for practitioners just as complicated as those that are more often encountered in non-summary compulsory windings-up. There is a need to grade the various kinds of work, however, and we consider that the model recommended should generally ensure that the most difficult work is carried out by Licensed Insolvency Practitioners.

3.18 We have included company secretaries following a submission by the Hong Kong Institute of Company Secretaries, which is the representative body for company secretaries in Hong Kong. The Institute submitted that its members were adequately qualified to carry out windings-up and we accept the Institute's contention that company secretaries already carry out a large number of liquidations. Members of the Institute are trained in a broad range of legal and accountancy management subjects and are also required to address insolvency issues in the Institute's corporate law and company secretarial practice examinations.

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[18] The *Consultation Paper* proposed the use of the expressions "*Official Liquidators*" and "*Registered Liquidators*" but these have been replaced because the word "*Official*" suggested a Government role, such as an association with the Official Receiver's Office, and "*Liquidator*" was replaced because more than just liquidation work would be undertaken. We are aware of the unfortunate acronyms, "*RIPS*" and "*LIPS*".

3.19 The authorities which would sanction inclusion as Licensed Insolvency Practitioners would be the Hong Kong Society of Accountants for accountants and the Law Society for solicitors. The authority for inclusion as Registered Insolvency Practitioners would lie with the Hong Kong Society of Accountants, the Law Society and the Hong Kong Institute of Company Secretaries. The exception would be the current List A Panel which would form the basis of the initial list of Licensed Insolvency Practitioners. The new Administrative Panel should then be expanded to include Registered Insolvency Practitioners.

3.20 We received a submission from the Association of Insolvency Officers, which is the representative body of Insolvency Officers grade working in the Official Receiver's Office. The Association submitted that Insolvency Officers should, as with their counterparts in the private sector, be eligible to obtain licences under the proposed licensing scheme. Their working hours on insolvency work should be recognised as the qualifying hours. We would support this submission provided insolvency officers could satisfy the requirements set out above.[19]

Provisional supervision

3.21 Only Licensed Insolvency Practitioners, and, in exceptional cases, company doctors,[20] that is persons who can demonstrate that in a particular circumstance they are the most appropriate persons to act as provisional supervisor, can act as provisional supervisor. A provision for the appointment of company doctors has already been recommended in the Commission' s *Report on Corporate Rescue and Insolvent Trading*. In practice, we anticipate that a proposed company doctor who sought to act as a provisional supervisor would look to the Official Receiver for licence approval before going to the court for sanction.

The "Grandfather" exemption

3.22 In addition to those practitioners who are already on the Administrative Panels, we are aware that there are also a number of qualified and experienced practitioners working in Hong Kong at present who might not be in a position to comply with the criteria for qualification set down for inclusion on the Administrative Panels. We **recommend** that, in establishing the expanded Administrative Panel, the Official Receiver should have the power, for a limited period, to appoint those experienced practitioners to the Administrative Panel even though they do not conform with the criteria set down for admission.

3.23 We put forward the "*grandfather*" exemption with the aim of securing for the Administrative Panel people of proven ability and experience in Hong Kong. The pool of professional insolvency talent in Hong Kong is relatively small and we consider that it would be short-sighted to exclude persons with proven ability. The "*grandfather*" exemption would have a precedent in the Insolvency Act which established the insolvency practitioner provisions in the United Kingdom. We would

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[19] See paragraph 3.9.

[20] A company doctor refers to an experienced businessman, with no particular professional qualifications, who is brought into an established, but uncompetitive or unprofitable, company to restore the company to a competitive and/or profitable situation.

note that the "*grandfather*" exemption might also apply to the most experienced Insolvency Officers of the Official Receiver's Office.

Training and continuing education

3.24 We do not make any recommendations for training and continuing education. We consider that these recommendations are just a start and that ultimately the Law Society, the Hong Kong Society of Accountants and the Hong Kong Institute of Company Secretaries will establish examinations, as has been the case in the United Kingdom and Australia.

Two practitioners per firm

3.25 We considered whether it should be a requirement that two Licensed Insolvency Practitioners from each firm should be available for any appointment from the Administrative Panels, that is, in respect of work that would be carried out by Licensed Insolvency Practitioners. It has, however, been pointed out that even large firms could have difficulties in this regard. We therefore **recommend** that, as a practical solution, one Licensed Insolvency Practitioner and one Registered Insolvency Practitioner may be appointed from a firm in cases where a Licensed Insolvency Practitioner must be appointed.

Indemnity / Bonding[21]

3.26 The question of indemnity and bonding is being considered at present by the Official Receiver and other bodies. There are proposals to replace bonding with professional indemnity insurance. The details are not finalised as there are unresolved issues and we consider that this is a matter that is best left to the Official Receiver and the professional bodies concerned.

Bankruptcy Ordinance

3.27 We note that the Bankruptcy Ordinance would need to be amended to accommodate these recommendations.

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[21] Note the recommendation at paragraph 12.31.

Chapter 4 - Remuneration (Fees) of Office-holders[22]

4.1 The *Consultation Paper* made little reference to the remuneration of office-holders. Since the publication of the *Consultation Paper* in April 1998, there have been developments in the approach of the court to the question of remuneration. Because of this, the recommendations made in this chapter have not been subject to the full consultation process.

4.2 We have, however, consulted the representative bodies of those who would be most likely to be affected by the recommendations, that is, the Law Society, the Hong Kong Society of Accountants and the Hong Kong Institute of Company Secretaries. The bodies expressed broad support for the recommendations. We note, however, that the recommendations set out below in relation to the convenor were not addressed to the bodies as they evolved after the bodies' submissions were received.

4.3 We do not intend to focus any more than necessary on cases that have been or are before the court on fees as the recommendations attempt to look forward having taken account of the developments both here and in the United Kingdom.

4.4 We need, however, to refer to the *Peregrine case*[23] to set out recent events in Hong Kong, as this case more than any other has established the court's approach to office-holders' fees in Hong Kong. The *Peregrine case* relates, for the most part, to the fees of the provisional liquidators of the Peregrine group of companies which were wound-up by the court in January 1998. The fees of the provisional liquidators in the *Peregrine case*, and in other cases, have been the subject of scrutiny by the court.

4.5 The Companies Ordinance does not make provision for the remuneration of provisional liquidators. It is accepted that a private provisional liquidator is entitled to sufficient remuneration to compensate him for the work done, so long as it is properly earned. A provisional liquidator may be appointed once a petition to wind-up a company has been presented and before a winding-up order has been made under section 193 of the Companies Ordinance and, in any event, under section 194, a provisional liquidator acts in all cases after a winding-up order has been made up to the appointment of a liquidator by the first meeting of creditors.[24]

4.6 Questions have been raised in the United Kingdom over the fees of not just liquidators and provisional liquidators, but other office-holders, which culminated in a *Report of the Ferris Committee* "*the Ferris Report*"[25] which itself moderated its

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22 For definition of "*Office-holder*" see paragraph 12 of the Introduction.
23 See *re Peregrine Investments Holdings Ltd.* [1998] 3 HKC 1 CFI.
24 Note the Companies (Winding-up) Rules, rules 28, 146 and 147.
25 Report of Mr. Justice Ferris' Working Party on the remuneration of office-holders and certain related matters.

tone from comments originally made in the "*Maxwell case*" where Ferris J. had taken a strong view on an application for fees by receivers.[26]

4.7 The Hong Kong court considered that office-holders were:

> "... *fiduciaries charged with the duty of protecting, getting in, realizing and ultimately passing on to others assets and properties which belong not to themselves but to creditors or beneficiaries of one kind and another.*"

The court continued that:

> "*The allowance of remuneration to office-holders represents an exception to the rule that a trustee must not profit from his trust which rule applies to all kinds of person who are in a fiduciary position. This exception inevitably involves a conflict between the interests of the fiduciary who is to receive such remuneration and the interests of those to whom the fiduciary duties are owed, who will bear whatever remuneration is allowed.*"

4.8 The comments of the court in the *Peregrine case* came after the comments in the *Maxwell case* but before the *Ferris Report*.

4.9 The usual method of charging fees for provisional liquidators, receivers and other office-holders in Hong Kong has been on a time costing basis but a scale or percentage basis may also be appropriate. There was no dispute about the level of time cost scale of fees charged by the provisional liquidator in the *Peregrine case* or, generally, in other cases. The concern of the court was on how the fees had been charged. The court raised serious questions about the way that provisional liquidators have been accumulated their fees and made harsh comments about "*cosy relationships*" in the insolvency business.

4.10 The court expressed astonishment that accounting firms in Hong Kong did not time cost their work in the same way as firms of solicitors. Solicitors generally charge in units of 6 minutes and are therefore able to account for how every six minutes is spent. The practice of accountants has been to charge on a more general basis with the consequence that they are unable to account for fees in the same detail as solicitors.

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[26] *Mirror Group Newspapers v Maxwell* [1998] BCC 324, the "*Maxwell case*". It should be noted that the assessment of the fees of the receivers was allocated to a Chief Master who delivered a judgment on 12 January 1999 which allowed about 99 per cent of the receivers' fees. The Master approached the assessment by applying the test of reasonableness under RSC Order 62, rule 12(1), (that is, that of a sensible solicitor considering what, in the light of his then knowledge, was reasonable in the interests of his client) and without using hindsight, in accordance with the decision in *Francis v Francis & Dickerson* [1955] All ER 836. The Master distinguished the *Maxwell case* to the extent that during his lifetime Mr Maxwell had portrayed himself as a man of immense wealth controlling a range of large multinational companies which were themselves of great value but that subsequent investigations showed that much of this was a facade and the true ownership of assets could only be established by the office-holders after the most painstaking investigation. The Master also noted that had the office-holders not investigated all leads in respect of the property potentially belonging to the estate of Mr Maxwell they would have been open to the severest of criticism. (Extracted from a synopsis of the judgment of Chief Master Hurst prepared by Wilde Sapte, Solicitors, London).

4.11 This fine and important distinction is not just a Hong Kong practice and the *Ferris Report* acknowledged that the time costing practices of solicitors had developed through many years of scrutiny of their bills by Taxing Masters in the courts whereas accountants had not been subject to such scrutiny. This distinction might not have been apparent to the Hong Kong court when some of its comments in the *Peregrine case* were made.

4.12 The point to be taken is that the court considers that it is a matter of public interest that the matter of fees of office-holders should be open and above board. That the court has support for this view is clear in that submissions on the *Consultation Paper* have made a number of references to remuneration of office-holders. It is also clear that insolvency practitioners would also like to see matters clarified. This is what these recommendations seek to achieve.

How office-holders' fees are treated at present

4.13 The *Ferris Report* identified eleven types of insolvency related practice. As stated, the Companies Ordinance does not adequately address the remuneration of the different types of insolvency practitioner and it might not be the best solution to lay down rigid rules in this respect. We consider that it would be appropriate to set out guidelines within which office-holders should operate.

4.14 At present there is no one body, including the court, which is qualified to consider all aspects of remuneration / fees that arise in an insolvency. These fees range from:

- the fees of a receiver appointed by a debenture holder in realizing sufficient assets to cover the amount owed under the debenture (the company might not even be insolvent);
- the fees of liquidators, including provisional liquidators;
- the fees of solicitors and agents appointed by liquidators; and
- the fees of provisional supervisors when new corporate rescue legislation is introduced.

4.15 The Taxing Master is capable of dealing with legal fees but not necessarily with the fees of liquidators, which relate to a different discipline. There are even questions about the jurisdiction of the Taxing Master to adjudicate on liquidators' or provisional liquidators' fees. The court is probably less qualified than a Taxing Master to consider fees and, in any event, would not have the time to investigate fees in detail.

4.16 Office-holders are expected to make sure that the fees of their solicitors and special managers are reasonable and provide value for money. The extent to which this obligation might or might not have been honoured in the past is not relevant for the purposes of this report as, rightly or wrongly, the "*cosy arrangement*" genie is out of the bottle and needs to be addressed.

The Ferris Report

4.17 The *Ferris Report,* which was published in August 1998, considered:

> "*the remuneration of office-holders and the amount to be allowed for disbursements paid or to be paid by an office-holder to solicitors*."

4.18 The *Report* considered the general basis on which remuneration should be fixed including the Official Receiver's scale of fees, percentages of assets realized or distributed, on a *quantum meruit* with or without a ceiling, by agreement between the parties and even on a contingency basis.

4.19 For the purposes of this report, we note that there was no dispute about the scale fees basis of charging fees for liquidators, provisional liquidators and others: the question was whether fees were properly charged. It might be the work of some other body to look at scale fees at a later date but, for now, we **recommend** retaining scale fees as the method of establishing fees.

4.20 The *Ferris Report* noted that the Insolvency Act provided two formulae for assessing remuneration. The *Report* opted for what it termed the "Provisional Liquidator formula (*PL formula)*", being the formula used in the Insolvency Rules, rule 4.30, over what it termed "*the Liquidator Formula*" in the Insolvency Rules, rule 4.127, on the basis that (i) the *PL formula* treated time spent in a more logical way (as one of several factors which had to be reviewed in conjunction with each other, not as a separate factor) and (ii) the *PL formula* was expressed in such a way as to make these factors of general relevance in assessing remuneration instead of appearing to confine that relevance to the choice between adopting a percentage of asset value or time spent as the basis of remuneration.

4.21 The *PL formula* factors are:

- time spent,
- complexity or otherwise,
- exceptional responsibility assumed,
- effectiveness of performance, and
- value and nature of the property dealt with.

4.22 We **recommend** the *PL formula* as a guideline for office-holders, and for application by the Panel we refer to below.

4.23 The *Ferris Report* also considered a number of other criteria for assessing remuneration but felt that the *PL formula* factors already contemplated these other criteria. We **recommend**, however, the addition of one of the other criteria to the *PL formula*. The *Ferris Report* referred to the criterion of "*the need for and desirability of investigatory work leading to additional realizations.*"

4.24 We **recommend** the adoption of an amended version of this test, that of "*the need for and desirability of investigatory work* ***which may or may not*** *lead to additional realizations"*. We consider that while the question of remuneration and realizations are important, there is also an underlying need for a proper minimum statutory investigations of companies and that realizations are not the only issue that need to be considered in assessing the reasonableness of remuneration. We expand

on this subject in comments in the chapter on the funding of the Official Receiver's Office.[27]

4.25 If we take issue with anything that has come out of the *Ferris Report,* it is to the extent that the *Report* tends to dwell on value for money and realizations in assessing the actions of office-holders. We consider that while realizations are important and while it is important to ensure that office-holders do not squander creditors' money on investigations or proceedings with little merit or prospects of recovery, there must be some outlet, for example, for a liquidator and a committee of inspection to decide to take an action where the prospects of a favourable outcome are uncertain or to spend money on investigations into the actions of officers of a company which may not necessarily bear fruit. If nothing ultimately results from such an action, an office-holder should not expect to be prejudiced in terms of his remuneration. We would note that this approach has parallels with the comments made by the Chief Master in his assessment of the fees of the *Maxwell case*.[28]

The need to establish a Panel to scrutinise office-holders' fees

4.26 The solution, we **recommend**, is to establish a Panel that would adjudicate all insolvency fees brought before it.

How the Panel / Convenor would operate

4.27 We **recommend** that the Panel should be established under the auspices of the Official Receiver.

4.28 We are concerned that the Panel should not have the effect of adding greatly to the costs of an insolvency proceeding. For this reason, we **recommend** the establishment of a system under which every application to the Panel would be considered in the first instance by a convenor who would make an assessment of the merits of the application. Other advantages of a convenor would be that the convenor would be in a position to apply with consistency the rules and precedents that would be established over a period of time and the convenor would be able to do so more quickly than a Panel.

4.29 A Panel would be formed only where one of the parties concerned was not prepared to accept the assessment of the convenor. In such circumstances a Panel would be appointed by the Official Receiver from the Panel list to consider the application and to make a final decision which would not be subject to any appeal.

The Panel to consider disputes as to fees only in cases referred to it

4.30 Looking at the overall picture of insolvency cases, it would be impractical and expensive to provide that fees in every insolvency matter should be brought before the Panel. In an average year, there are over 1,000 members' (solvent) voluntary windings-up, over 200 creditors' (insolvent) voluntary windings-up and about 450 windings-up by the court, not to mention receiverships and bankruptcy. In terms of the three figures quoted above alone, the Panel would need to consider up to six cases per day based on a 5-day working week.

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27 See paragraph 5.15 and paragraphs 11.41 and 11.42.

28 See the footnote to paragraph 4.6.

4.31 We **recommend** therefore that the fees of office-holders, and those of their agents, such as solicitors, save where otherwise taxed, should be capable of being referred to the Panel only in the event of a dispute as to fees. We reiterate that the Panel would not be involved in the fixing of fees, merely in assessing whether the fees have been properly charged and spent.

Who would be on the Panel

4.32 We **recommend** that the Panel should be made up of Licensed and Registered Insolvency Practitioners when established (but until then by insolvency practitioners appointed to the Official Receiver' s List A Panel and List B Panel), other professionals to be identified, representatives of the Official Receiver's Office and representatives from bodies such as the Protection of Wages on Insolvency Fund Board and the Consumer Council.

4.33 This last recommendation was not greeted with enthusiasm by two of the bodies consulted on the recommendations on the basis that representatives of lay bodies such as the Consumer Council would generally have no experience or knowledge of insolvency procedures or the work of office-holders. It was also stated that it was unclear how the Consumer Council, for instance, could be considered an interested party or what role would be envisaged for them on the Panel.

4.34 There is, however, the need for openness and the need to avoid the Panel being perceived as being part of a cosy relationship. The presence of representatives of bodies such as the Consumer Council would serve to dispel such perceptions. It is clear that the court sees an element of public interest in the fees of office-holders and submissions on the *Consultation Paper* echoed this view. Lay representatives would quickly accumulate the necessary knowledge to assess claims for remuneration. We would also remind office-holders that the Panel would not consider the level of fees but only how fees had been incurred and whether the fees were reasonable in the circumstances.

4.35 A panel of three would sit in every case referred to it. The composition of each Panel would be made up of different representatives from the areas of interest identified above. This mix on Panels should serve to dispel doubts about self-regulation maintaining high fees.

Access to the Panel

4.36 We **recommend** that the court, the Official Receiver and office-holders should have the right to apply to the Panel as of right. The court and the Official Receiver would therefore be able to refer fees that it considered questionable to the Panel for assessment and final decision. Office-holders should be able to apply as of right in the event that creditors or debenture holders would not agree to their fees. In an application by the court or by the Official Receiver, the costs of the Panel would be borne by the estate. In the event of an application by an office-holder, the costs would be paid by the office-holder subject to an indemnity from the estate.

4.37 We **recommend** that creditors, debenture holders and others who may have an interest in the fees of an office-holder should only have access to the Panel by application to the court. In such cases, the costs of the application should be decided by the court depending on the outcome of the assessment. The reason for this is to ensure that applications to the Panel would be of substance. The court would act to exclude misconceived or nuisance applications.

How the Panel would charge

4.38 We **recommend** that the Panel should be self-funding. The administration of the Panel would be carried out by the Official Receiver and the funding of the Official Receiver's Office in this regard would need to be addressed. The intention would be that the administration costs of the Official Receiver's Office and the costs of Panel members would be covered by fees charged.

4.39 The Panel could charge on the scale employed by the Taxing Master, who charges six per cent of the amount of fees allowed up to $100,000, four per cent for the next $150,000, three per cent for the next $250,000 and one per cent for the remainder.[29] We anticipate that the fees of the Panel would be lower. This should be the case, particularly in cases, which should be the majority, where an assessment by the convenor is not referred to the Panel.

Panel to be inquisitorial

4.40 We **recommend** that the Panel should have inquisitorial powers along the lines of the powers enjoyed by the Taxing Master.[30] The Taxing Master, in the discharge of his functions may, among other things:

- take an account of any dealings in money made in connection with the payment of the costs being taxed;
- examine witnesses; and
- direct the production of documents.

[29] See the High Court Fees Rules (Cap. 4), First Schedule, paragraph 19.
[30] See The Rules of The High Court (Cap. 4), Order 62, rule 14.

Chapter 5 - The Role and Funding of Official Receiver' s Office

5.1 We **recommend** that the Government, through the Official Receiver's Office, in the public interest, should take a more positive role in the enforcement of proper investigatory provisions and the establishment of regulatory procedures that would apply to all companies that go into liquidation, whether assetless or otherwise.[31] In doing so, the Government would be required to invest in the funding of the Official Receiver's Office to a level under which the Official Receiver's Office would be able to carry out this role. The Government, in doing so, would only be allocating resources that have already been extracted from companies in the form of the business registration fee.

5.2 The *Consultation Paper* noted that the Official Receiver's Office traditionally operated at a deficit, with the annual shortfall being met out of Government revenues. In its *Annual Departmental Report for 1997/98*, the Official Receiver reported a deficit of $20.2 million of expenditure over revenue. In 1996/97, the deficit was $10.2 million. The actual deficit is, however, much more as the departmental expenditure recorded in the *Annual Departmental Reports* does not represent the total cost of operating the Official Receiver's Office which includes accommodation costs for premises occupied, staff oncosts, depreciation and costs of services provided by other departments and policy bureaux.

5.3 The *Consultation Paper* said that there was evidence to suggest that with the increase in the contracting out of remunerative, non-summary, cases to private sector liquidators, the Official Receiver's Office annual deficit was liable to increase to some extent. This may be borne out by the increase in the deficit between 1996/97 and 1997/98 of $10 million.

5.4 We consider that it is important in the overall context of regulation and practice of the winding-up of companies that the Official Receiver's Office should be adequately funded.

Protection of Wages on Insolvency Fund levy on the business registration fee

5.5 The *Consultation Paper* proposed that the Government should consider allocating a fixed proportion of the business registration fee in order to assist in the funding of the Official Receiver's Office and implied that the proportion should be taken out of that part of the fee that was allocated to the Protection of Wages on Insolvency Fund. The business registration fee is an annual registration fee charged on every company. Currently, the fee stands at $2,250 per annum of which $250 is diverted to the Protection of Wages on Insolvency Fund.

Adequate and appropriate funding of the Official Receiver's Office

31 Note the recommendation made in paragraph 11.42 and the comments in paragraphs 11.41 and 11.42.

5.6 We have received considerable opposition to the notion of funding the Official Receiver's Office from that part of the business registration fee that is paid to the Protection of Wages on Insolvency Fund and we retreat from that proposal.

5.7 We remain of the view that the Official Receiver's Office should be adequately funded and we set out below options that should be considered by the Government. The Official Receiver has a role to play in the administration of business in that it is involved in all aspects of the winding-up of companies, both as a liquidator and as a regulator. There is even a business interest in the administration of bankruptcy, albeit less distinct, in that many bankruptcies relate to the bankrupting of individuals operating their own businesses.

The need for proper regulation of the winding-up of companies by the Official Receiver's Office

5.8 The winding-up of companies relates directly to the administration of businesses. This point was brought out in the *Cork Report* in the following terms:

> *"It is sometimes argued that the function of insolvency law is simply the distribution of the proceeds of the insolvent's assets amongst his creditors, giving him, where appropriate, personal relief from their claims. This has never been the English approach. The policy of our insolvency laws has always been far more complex; at least two other major objectives will be found to have existed:*
>
> *(a) the insolvency laws are treated by the trading community as an important instrument in the process of debt recovery; the threat or imminence of insolvency proceedings as a weapon in persuading a defaulting debtor to pay or make proposals for the settlement of a debt cannot be underestimated as it constitutes, in the majority of cases, the sanction of last resort for the enforcement of obligations;*
>
> *(b) the insolvency laws, through their investigative processes, are the means by which the demands of commercial morality can be met; any disciplinary measures against the debtor which may appear necessary in the light of this investigatory process can be imposed either inside the insolvency proceedings themselves or outside, for example, by the machinery of the criminal law or by professional disciplinary bodies."* [32]

5.9 We submit that Hong Kong insolvency law operates on the same basis as the English insolvency process. We also submit that the termination of businesses relates directly to the administration of business. The Official Receiver's Office, however, receives no benefit from the business registration fee, the balance of which, we understand, is paid to the Inland Revenue Department.

5.10 This point is relevant to an issue raised by the Secretary for Financial Services in a submission on the *Consultation Paper* proposals. In his submission, the Secretary for Financial Services referred to the question of the funding of the Official Receiver's Office:

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32 *The Cork Report*, paragraph 235.

" ...as I see it, the funding issue is more conspicuous with the ' non-remunerative or ' summary' cases. In this connection, I would like to share some facts and figures of the Official Receiver's Office. In 1997 alone, 87% of the compulsory winding-up cases were administered under the summary procedure as provided under section 227F of the Companies Ordinance where the assets of the company concerned are not likely to exceed $200,000 in value. In over 80% of the compulsory winding-up cases, the actual amount of assets realised is less than $50,000 - the benchmark figure below which the assets recovered would not be sufficient even to cover the Official Receiver's fees and costs, let alone distribution to the creditors.

As Hong Kong's economy has become highly service-oriented and an average company nowadays does not necessarily need to have much assets for production, it is likely that the trend of increase in both the number and proportion of ' non-remunerative' cases will continue. This phenomenon explains why the Official Receiver's Office has been operating with an increasing annual deficit. Chapter 26 of the Consultation Paper refers to the Pilot Scheme launched by the Official Receiver's Office since September 1997 to contract out summary cases to private sector practitioners. I would like to add that under the Scheme, the Government pays a subsidy of not more than $60,000 per case where the assets realised in such cases are insufficient to cover the fees chargeable by the private sector practitioner.

If the Pilot Scheme is to be expanded into a regular contracting out scheme and the existing practice of providing a fixed subsidy continues, substantial amounts of money from the General Revenue will continue to be needed to fund the scheme. Although this would mean additional expenditure, ' contracting out' is still a far more preferable option than the other (only) alternative, which is to continuously expand the Official Receiver's Office thus increasing the overall expenditure (especially on the recurrent side) of the department year over year. This option is also unrealistic because resources are not unlimited and any increase in staff can never catch up with the speed of increases in workload.

The Sub-committee has proposed that the Government should consider ' allocating a fixed proportion of the business registration levy' in order to assist in the funding of the Official Receiver' s Office. I see two matters of principle in this proposal.

First, the proposal would bring about a fundamental change to the purpose for which the levy was introduced. The purpose of the levy is to establish the Protection of Wages on Insolvency Fund (' the Fund' ') in order to provide ex-gratia payment to employees who are owed arrears of wages by their insolvent

> *employers. The Sub-committee's proposal will be tantamount to using the levy to subsidise employers and creditors in winding up failed businesses. I cannot agree to the proposed change in the use of the levy in the absence of any compelling justification, especially on grounds of public interest.*

Second, I wonder whether the ' problem' could be tackled at its root. As mentioned above, over 80% of the company winding-up cases are either ' non-remunerative' or ' assetless' . It may be worthwhile to explore the possibility of streamlining or fast-tracking certain statutory procedures for processing these summary cases with a view to saving both the time and cost of the liquidator, cutting down the expenditure of the Official Receiver's Office and helping reduce the amount of Government subsidy to the insolvency service. In addition and more specifically, I would like the Sub-committee to look at the possibilities of reducing the statutory role of the Official Receiver in the administration of insolvency cases, and, as a connected matter, the scope for private sector practitioners, under some form of authorisation, to take over some of the statutory duties of the Official Receiver."

5.11 We respectfully take issue with some of the comments of the Secretary. The Secretary stated that the proposal for funding from the business registration fee would be tantamount to using the fee to subsidise employers and creditors in winding-up failed businesses. The Secretary could not agree to the use of the fee in the absence of any compelling justification, especially on the grounds of public interest.

5.12 While we acknowledge that the idea of taking money from that part of the business registration fee that is paid to the Protection of Wages on Insolvency Fund is misconceived, we can see a direct connection to the use of some of the balance of the business registration fee being used to fund the Official Receiver's Office.

5.13 For years there have been collapses of large companies and financial institutions in Hong Kong which have attracted no deep investigation as the regulatory provisions have not been in place. We state, unreservedly, that there is a vital public interest in having a clean and open insolvency regime with a proper investigatory framework. We consider that the need for enhancing the role of the Official Receiver's Office so as to be capable of fulfilling this role is of great importance for the business community and the society of Hong Kong as a whole.

5.14 The Secretary also referred to the case of assetless companies and asked the Insolvency Sub-committee to look at the ways of streamlining the statutory procedures for processing assetless cases, for ways in which the statutory role of the Official Receiver's Office could be reduced in the administration of insolvency cases and to look at ways for private insolvency practitioners to take over some of the statutory duties of the Official Receiver.

5.15 These comments are at odds with the direction we consider should be taken. In terms of the winding-up of insolvent companies, we do not agree that the statutory investigation of these companies should be compromised by streamlining. All that would create would be opportunities for dishonest directors, and there are many, to use their companies to accumulate debt and go into liquidation, thereby cheating their creditors without much concern about statutory redress. This problem

persists and it cannot be tackled without a commitment from Government to allocate resources to proper regulation. That function should be carried out by the Official Receiver. It is not a function for private sector liquidators, whose role should be to recover assets. We have commented on this elsewhere in this report and we note that the Hong Kong Association of Banks agreed with us on this important issue.[33]

5.16 We would be concerned if the comments of the Secretary for Financial Services represent a Government policy of reducing the statutory regulation of insolvent companies. We consider that such regulation should, as a matter of policy and practice, be a policy of Government and should be carried out by Government through the Official Receiver's Office.

5.17 The question of how this should be funded follows on from this standpoint. We have pointed out that the $2,000 remaining from the business registration fee paid by each company would be appropriately applied to business if part of it is used to adequately fund the Official Receiver's Office to a level where it could fulfil its statutory requirements. Since the Protection of Wages on Insolvency Fund received $181.1 million in respect of its levy from the business registration fee in 1997/98 it would appear that the balance that went to the Inland Revenue Department would have been $1.341 billion.[34]

5.18 The question of how the Official Receiver's Office should be funded is, however, a matter for the Government and we can only point towards certain options. In addition to the business registration fee, we note that the Companies Registry, which is a trading fund within the terms of the Trading Funds Ordinance (Cap. 430), achieved a surplus of $56 million in the year 1997/98, which was a decrease of 16% from the previous financial year.[35] We mention the Companies Registry' s profitability merely to demonstrate that other aspects of the administration of companies are profitable and that there is a strong argument that some of the monies collected from companies should be used in the administration of the termination of businesses. The fact that the Companies Registry and the Official Receiver's Office are different Government Departments is neither here nor there in term of the proper administration of companies from cradle to grave and proper commitment and allocation of resources should be committed to the final part of the process.

5.19 A further option for the funding of the Official Receiver's Office would be to increase the fee that the Official Receiver's Office can charge on interest earned on investments under section 295 of the Companies Ordinance. At present, the Official Receiver's Office is entitled to charge 1.5% per annum on interest earned. We note that the Insolvency Service in the United Kingdom is entitled to charge the equivalent of 2.5% per annum on interest earned and that in both 1996/97 and 1997/98, the fee on interest earned represented over 55% of the total income of the Insolvency Service.[36] The Official Receiver' s Office' s income from fee on interest earned represented 31% of total revenue in the financial year 1997/98 and 33% in 1996/97.[37]

5.20 If the fee on interest earned by the Official Receiver's Office of 1.5% had been 2.5%, the Official Receiver's Office would have increased revenue from bank interest from $26.6 million to $44.3 million, a difference of $17 million, which

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33 See paragraph 11.42.

34 See the *Inland Revenue Department, Annual Report, 1997/98*, page 8.

35 *Companies Registry Annual Report 1997/98*, page 5.

36 The *Insolvency Service, Annual Report and Accounts 1997/98*, page 50.

37 *Official Receiver's Office, Annual Departmental Reports for 1997/98 and 1996/97*, Annex 17.

would have virtually wiped out the actual deficit of $20.2 million. We note, however, that the 1.5% fee has been vigorously opposed by practitioners on the ground that creditors in a liquidation are already unlikely to recover the full amount of their debts. We also note that the Official Receiver has, in some large liquidations, reduced the amount of his fee, with the prior approval of the Financial Secretary.

5.21 A further option that may be considered would be increasing the petitioner's deposit which currently stands at $12,100 under the Companies (Winding-up) Rules, rule 22A. We would advise against the petitioner's deposit being increased significantly as a means of funding the Official Receiver's Office.

Chapter 6 - Renaming of Members' (Solvent) Voluntary Winding-up and Creditors' (Insolvent) Voluntary Winding-up

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6.1 We have noted that the terms "*members' voluntary winding-up*" and "*creditors' voluntary winding-up*" create confusion even among legal and accountancy professionals who might not deal regularly with the winding-up provisions. The terms are not intuitive in that they do not convey their function in their description.

6.2 We consider that the expressions "*solvent voluntary winding-up*" and "*insolvent voluntary winding-up*" are expressions that explain their function without the need for further inquiry. We **recommend** that these expressions should replace the references to "members' voluntary winding-up" and "creditors' voluntary winding-up" in the Companies Ordinance and other legislative provisions.

6.3 These recommendations would involve amendments being made to the definitions of the two expressions under section 2 and section 233(4) of the Companies Ordinance. We **recommend** that the definitions, and all Part, sub-Part and section headings should contain the new expression in brackets.[38]

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[38] A practice that is followed in all references to "creditors' (insolvent) voluntary winding -up" and "members' (solvent) voluntary winding-up" in this report.

Chapter 7 - Minorities

Section 168A Alternative remedy to winding up in cases of unfair prejudice

7.1 This section does not form part of the winding-up provisions of the Companies Ordinance. It comes under Part IV of the Companies Ordinance (Management and Administration) and provides minority members of a company with a remedy in cases of unfair prejudice. The Companies (Winding-up) Rules, rule 1, applies the Companies (Winding-up) Rules to section 168A.

7.2 The section provides that a member of a company who complains that the affairs of the company are being conducted in a manner unfairly prejudicial to the interests of members generally, or of some of the members, including himself, may petition the court for an order under the section.

7.3 The provision is used frequently though in the context of solvent, not insolvent, companies. We do not intend to comment on the section except insofar as it relates to the general body of the winding-up provisions.[39] We note that the *Review of the Hong Kong Companies Ordinance* has made specific recommendations in relation to the unfair prejudice or oppression remedy.[40]

Companies Winding-up proceedings and Miscellaneous proceedings distinguished

7.4 The Official Receiver's Office submitted that:

> *"A petition under section 168A should be exempted from the requirement to pay a deposit to the Official Receiver, who has no involvement in such petitions."*

7.5 We understand that the question of whether or not a deposit is required depends on whether the proceedings are described as "*Miscellaneous Proceedings*" or "*Winding-up Proceedings*".

7.6 Petitions under section 168A usually attract a miscellaneous proceeding number but if a petition contains a prayer for a winding-up order as an alternative, the case would be allotted a winding-up number and so attracts a deposit under the Companies (Winding-up) Rules, rule 22A, because it would come under the winding-up jurisdiction. The alternative prayer for a winding-up order would usually be made on the just and equitable ground under section 177(1)(f).

7.7 We **recommend** that in the event that a miscellaneous proceeding does contain a prayer for a winding-up order, the proceeding should be allocated a

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39 See Companies (Winding-up) Rules, rules 22A and 23A.

40 *Review of the Hong Kong Companies Ordinance*, paragraphs 7.08 and 7.09.

winding-up number and the Companies (Winding-up) Rules should then be observed and a deposit paid, but not otherwise. This would mean that a proceeding would have both a miscellaneous proceeding number and a winding-up number but we cannot see how this can be avoided.

Chapter 8 - Contributories

Section 170 Liability as contributories of present and past members[41]

8.1 The section makes general provision for the circumstances under which contribution by contributories may be made to the assets of a company which is being wound-up.

Liability of past directors and shareholders

8.2 The Insolvency Act, section 76, provides that where a payment has been made out of the capital of a private company for the redemption or purchase of the company's shares, and the company is wound-up as insolvent within a year of the date of the redemption or purchase, the recipient of the payment may be obliged to repay the amount paid in whole or in part. In addition, the directors who made the statutory declaration for the purposes of the redemption or purchase may also be jointly and severally liable to make repayment with the recipient.

8.3 There is no corresponding provision under the Companies Ordinance and, as it would be useful to set out the potential liability of past directors and shareholders, we **recommend** that the provision be placed in the Companies Ordinance. We received one submission to the effect that the potential liability should be extended to a two-year period and that a liquidator should be obliged to demonstrate that the company was insolvent at the date of redemption or purchase as, otherwise, a share purchase in good faith followed by a catastrophic event which left the company insolvent could place an unexpected and unfair burden on the contributories. We do not support this submission.

Expanded circumstances where a contributory can present a petition

8.4 The adoption of a provision similar to section 76 of the Insolvency Act would effect a change in the circumstances of contributories. At present, contributories are entitled to petition for the winding-up of the company only in limited circumstances,[42] the policy behind which is to prevent a person from buying shares in order to qualify himself to harass or wreck a company. In addition, there is a common law requirement that a contributory normally has to establish a financial interest in the obtaining of an order and therefore a contributory whose shares are

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[41] Note section 180. It is not necessary for a contributory to prove that a company has a surplus available for distribution.

[42] Companies Ordinance, section 179(1)(a). The Insolvency Act equivalent is section 124(2). Note also section 257 of the Companies Ordinance.

fully paid up needs to establish that the company is probably solvent so that there is a prospect of a return of capital to the members at the conclusion of the winding-up.[43]

8.5 The new provision would upset the assumption behind the policy as, in this case, the contributory as petitioner would be faced with the prospect of personal liability and therefore he would have the standing to present a petition. The Insolvency Act has therefore provided[44] that a person who is liable under section 76 to contribute to the assets of the company may petition on the grounds as set out in the Companies Ordinance, section 177(1)(d) and (f)[45], that a company is unable to pay its debts or where the court is of the opinion that it is just and equitable that the company should be wound-up. We **recommend** that this provision should be adopted.[46]

8.6 We received a submission that to limit abuse of the provision a contributory who intended to present a petition should be obliged to obtain a certificate from a Master that his case passed the test for an action on which a petition could be presented. We do not support the submission.

Section 171 Definition of contributory

8.7 The Insolvency Act, section 79(3), provides that a person who is liable under section 76 of the Insolvency Act is not regarded as a contributory for the purposes of the articles of association of the company. We received no submissions on the point and **recommend** that this provision should be adopted.

Section 173 Contributories in case of death of member
Section 174 Contributories in case of bankruptcy of member[47]

Provision to apply before or after death of bankruptcy

8.8 It has been suggested that the use of the word "*contributory*" in these provisions assumed that a company had already been wound-up and it would follow that the sections assumed a pre-existing winding-up. We are unsure as to what the position would be if a contributory died before the winding-up. For the sake of clarity, we **recommend** that the provisions should state that they apply to a person who died either before or after the date of the winding-up.

Insolvent companies

8.9 No provision is made for the demise of insolvent companies, which are just as likely to be contributories as natural persons. We **recommend** that provisions should be made for insolvent companies in sections 173 and 174.

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43 *The Law of Insolvency*, Ian F. Fletcher, 2nd edition, page 535. See *Re Rica Gold Washing Co.* (1879) 11 Ch. D. 36.
44 Insolvency Act, section 124(3).
45 The Insolvency Act equivalent being section 122(1)(f) and (g).
46 Note the comments on contributories under section 180.
47 Note *Ng Yat Chi v Max Share Ltd. & Another* [1998] HKLRD 866 CFA.

Chapter 9 - Cases in which Company may be Wound-up by the Court

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Section 177 Circumstances in which company may be wound-up by court

9.1 In general terms, we feel that the provision works reasonably well. We received no specific submissions to change the circumstances under which a company may be wound-up.[48] The provisions are broadly similar to the provisions under the Insolvency Act, section 122.

Regulatory authorities

9.2 There are several Ordinances which allow regulatory authorities to wind-up companies. The Securities and Futures Commission, Office of the Commissioner of Insurance and the Hong Kong Monetary Authority, all have provisions to facilitate the winding-up of companies.[49]

9.3 We **recommend** that, while it is not necessary to cross-reference the provisions which provide regulatory authorities with the power to wind-up companies, it would be useful for a new section 177(1)(g) to be added to record that regulatory authorities have these powers. Such a provision would have the effect of giving notice to anyone checking the winding-up provisions that other relevant provisions exist. Alternatively, one submission suggested that a schedule to a new Insolvency Ordinance might contain all of the bases under which all of the regulatory authorities could wind-up a company as, once done, this would be easy to maintain and this information would be helpful to anyone looking at the subject. We leave this as a matter for the Law Draftsman as to which would be the best way of achieving the desired effect.

Section 178 Definition of inability to pay debts

9.4 Section 177(1)(d) provides that a company may be wound-up by the court if it is unable to pay its debts. Section 178(1) deems that a company is unable to pay its debts in three circumstances:

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48 Note, however, the *Review of the Hong Kong Companies Ordinance*, paragraph 7.11, which recommends that in an application for just and equitable winding-up under sub-section (1)(f), the court should be given the option of making any other order it sees fit and that the remedy should be dissociated from the more undesirable consequences of winding-up procedures in insolvency (such as freezing of bank accounts).

49 See the Securities and Futures Commission Ordinance (Cap. 420), section 45, the Insurance Companies Ordinance (Cap. 41), Part VI, and the Banking Ordinance (Cap. 155), section 122.

- if a creditor owed more than $5,000 serves a written demand for payment on the company and that demand is not satisfied by the company within three weeks of the demand; or

- if an execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied; or

- if it is proved to the satisfaction of the court that the company is unable to pay its debts, in which case the court shall take into account the contingent and prospective liabilities of the company.

9.5 We are broadly satisfied that these three circumstances are adequate for the purposes of petitioning to wind-up a company that cannot or will not pay its debts. We note that Hong Kong is not alone in providing for a demand that is not based on a judgement as both the Insolvency Act, section 123(1)(a), and the Australian Corporations Law, section 459F, make similar provision. We consider that to change this approach would add considerably to the costs and time involved in recovering debts and we would not support any change. We have made a number of recommendations that should assist in making the process easier to understand and operate.

Prescribed form

9.6 Section 178(1)(a) provides that a company shall not be able to pay its debts if the company has failed to comply with a demand in writing requiring payment. There is no prescribed form of statutory demand under the Companies Ordinance, although a statutory demand has been recently introduced in the Bankruptcy Ordinance.[50] We **recommend** that a statutory form should be adopted.

9.7 The Insolvency Rules[51] provides for a prescribed form of demand which must state or provide for the amount of the debt and consideration, any other charge, including interest, and the grounds for inclusion, a warning of intention to wind-up if payment is not made, the time within which to comply and possible methods of compliance, and how to contact the creditor. The Australian provisions also have a well laid out prescribed form of statutory demand.[52]

9.8 We understand that a prescribed form of statutory demand has been introduced in the Bankruptcy Ordinance. It would be appropriate for the form under these provisions to mirror the bankruptcy form. There should be no need for the form to be in a prescribed form and it should be capable of variation to suit any circumstances that may arise.

9.9 One submission on the *Consultation Paper* questioned what was meant in proposing a statutory form of statutory demand and then stating that it needed not be in prescribed form. The submission said that at the very least, it would seem sensible to prescribe by statute that certain particulars had to be contained in a

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50 Bankruptcy (Amendment) Ordinance 1996 (Ord. No. 76 of 1996), section 6A.

51 Insolvency Act, rules 4.4 to 4.6 and Form 4.1.

52 Australian Corporations Law, section 459E(2)(e), and Form 509H.

valid statutory demand and perhaps to provide an illustrative form which could be adapted to suit particular cases. That statement would reflect our intention that the statutory form should be in prescribed, but not required, form.

9.10 Another submission suggested that the statutory form should be bilingual and should state clearly the consequences of ignoring the document. The form of statutory demand would be set out in the Ordinance in both Chinese and English. It should be sufficient for a statutory demand to be served in either language. We agree with this submission that the statutory form should contain a statement of the consequences of ignoring the demand and **recommend** its adoption.

Presumption of insolvency

9.11 Recent Australian amendments have shifted the emphasis from a company being deemed to being unable to pay its debts to circumstances where it must be presumed by the court that a company is insolvent. A company is solvent if, and only if, the company is able to pay all its debts as and when they become due and payable.[53] Statutory presumptions also apply in relation to whether a company is insolvent. These include the failure to comply with a statutory demand, and the execution of a judgement or other process, in addition to cases where a receiver has been appointed over the property of a company.[54]

9.12 We find no fault with the Australian provisions, but consider that the current provisions, coupled with the recommendations, would be adequate.

Minimum debt amount under section 178(1)(a)

9.13 In terms of minimum debt amount, sections 177(1)(d) and 178(1)(a) combine to provide that a company is deemed to be unable to pay its debts if the debt claimed in the petition is for a sum exceeding $5,000. Section 178(1)(a) contemplates a creditor being able to point to a debt of a specified sum that cannot seriously be questioned, either as to its existence or its quantum.[55]

9.14 In the *Report on Bankruptcy*, the Commission recommended that the amount of the minimum debt under the Bankruptcy Ordinance, section 6, should be increased from $5,000 to $10,000, that the minimum debt amount should be reviewed annually and should be capable of amendment by subsidiary legislation rather than by amendment of the primary legislation.[56] This recommendation was adopted in the Bankruptcy (Amendment) Ordinance 1996.[57]

9.15 We **recommend** that the amount of the minimum debt under the Companies Ordinance should mirror the minimum debt amount in bankruptcy. Our reasons for the recommendation are the same as the reasons given in the *Report on Bankruptcy*, that a person, or company, should not be exposed to bankruptcy, or

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53 Australian Corporations Law, section 95A(1).

54 Australian Corporations Law, section 459C.

55 See *Hong Kong Company Law, Legislation and Commentary*, Roman Tomasic and ELG Tyler, Issue 1, I [9279].

56 Law Reform Commission of Hong Kong, *Report on Bankruptcy*, May 1995, Chapter 3.

57 Ordinance No. 76 of 1996, section 6(2)(a) and (5). The Financial Secretary may prescribe a greater amount. The Bankruptcy (Amendment) Ordinance 1996 came into effect on 1 April 1998.

winding-up, for an insignificant amount, a point borne out in practice where few petitions are presented for less than $10,000.

9.16 We received two submissions which suggested that the minimum debt amount should be higher than the $10,000 proposed, one submission suggesting a minimum debt of $25,000 and one submission linked the amount of minimum debt with the amount of the petitioner's deposit, stating that it was illogical to set the deposit higher than the minimum debt. The petitioner's deposit of $12,150 under Companies (Winding-up) Rules, rule 22A, is currently higher than the minimum debt amount.

9.17 The *Report on Bankruptcy* stated that there was a correlation between the amount of the statutory petitioner's deposit and the minimum debt amount and stated that the statutory deposit should be a fraction of the minimum debt. The *Report* added that recourse to bankruptcy proceedings, and by extension companies' winding-up proceedings, should be within the financial reach of as many people as possible. The *Report* also noted that the purpose of the statutory deposit was to finance the initial administration of the estate. It is clear that a balance needs to be struck between these two features.[58] We are no longer convinced that the statutory deposit should necessarily be less than the minimum debt. We **recommend** that provisions adopted in the Bankruptcy Ordinance to allow the Financial Secretary to prescribe a greater amount than the existing minimum debt should be adopted in the Companies Ordinance.[59] We would note that the minimum debt amount should not be increased to such an extent as to put it out of the reach of employees.

Deeming provisions under section 178(1)
Contingent and prospective liabilities under section 178(1)(c)

9.18 Section 178(1) provides that "*A company shall be deemed to be unable to pay its debts*" and lists the three circumstances set out in paragraph 9.4 above under which a company shall be so deemed.

9.19 Sub-section (1)(c) allows the court to make a judicial assessment of whether a company is unable to pay its debts. In doing so, the court shall take into account the prospective and contingent liabilities of a company. The *Consultation Paper* questioned whether this provision should be in the deeming provisions under sub-section (1) as the sub-section still requires that an inability to pay debts has to have been proved, and it seemed strange to have something that has to be proved as a deeming provision. The *Consultation Paper* noted that the reference to contingent and prospective debts had been dropped from the test in the corresponding provision of the Insolvency Act, section 123(2), and now formed a separate test from the other deeming provisions in the Insolvency Act.

9.20 It appears that the present wording of sub-section (1)(c) is contradictory, as it runs together two issues; (i) the question whether current debts can be met as they fall due, and (ii) the question whether the company can ultimately prove solvent if its future as well as its present liabilities are taken into account.

9.21 We received a submission which pointed out that prospective and contingent liabilities had no place in a "*cash-flow*" test like sub-section (1)(c), and that

58 *Report on Bankruptcy*, Chapter 4, paragraphs 4.9 to 4.14.
59 Bankruptcy Ordinance, section 6(2)(a) and (5).

section 123(2) of the Insolvency Act 1986 uses a "*balance sheet*" test where such liabilities could be taken into account. We take this point and **recommend** that a cash-flow test should be adopted in sub-section (1)(c) by replacing the current provision with the following wording, to the effect that a company shall be deemed to be unable to pay its debts "*if the company is unable to pay its debts as they fall due*". This wording would, we consider, apply a deemed inability to pay debts measured on a cash-flow basis.

9.22 We also **recommend** the adoption of a balance sheet test by the introduction of a new sub-section (1)(d) to the effect that a company should be deemed to be unable to pay its debts "*if the value of the company's assets is less than the amount of its liabilities, taking into account the contingent and prospective liabilities of the company*."

Service by e-mail or fax

9.23 We considered the possibility of proposing that certain matters might be capable of being served by fax or other electronic forms of communication. We recognise, however, that though there may be merit in the use of new forms of technology for the purposes of service of documents, it is not appropriate to make recommendations for insolvency as service relates to many other processes and the court will undoubtedly deal with these issues in due course.

Assignment of part of a debt

9.24 One submission noted that it appeared to be the law that an assignee of a part of a debt could not serve a statutory demand but could present a petition if he could prove that the company was insolvent.[60] The submission stated that the reason was that such an assignee could not enforce his claim to be paid that part of the debt without, as a matter of procedural law, joining in the assignor, who retained rights to the balance of the debt, so that the matter could be finally dealt with and in order to avoid conflicting decisions concerning the same debt. The submission stated that this was not satisfactory as assignment of only part of a debt met a commercial need where the assignment was required to secure or satisfy only a lesser sum, so that it was not possible to assign the whole debt, where such liabilities could be taken into account.

9.25 We note the submission but we are not inclined to support the idea of changing the law in this respect.

[60] *Re Steel Wing Co. Ltd.* [1921] 1 Ch 349.

Chapter 10 - Petition for Winding-up And Effects Thereof and Consequences of Winding-up Order

Section 179 Provisions as to applications for winding-up

10.1 The section provides that a petition to the court to wind-up a company may be presented by the company, any creditor or creditors, including contingent and prospective creditors, a contributory or contributories, or any combination of those parties. Certain special conditions apply to petitions by contributories and contingent or prospective creditors.[61] The section also makes provision for the Financial Secretary and the Registrar of Companies to wind-up companies in certain cases.[62]

Directors to be able to petition to wind-up

10.2 Directors are not included in the list of those who are able to petition for the winding-up of a company under the section. The situation is different under the Insolvency Act, section 124(1), which specifically provides that directors are able to present a petition to wind-up. This provision was introduced to overcome a court decision to the effect that the former practice of allowing the directors of companies to petition for the winding-up of a company based on a resolution of the directors was wrong.[63]

10.3 Even now, it appears that under the Insolvency Act directors must petition in their own names rather than in the name of the company and that they ought to act unanimously in the absence of a decision of the board of directors.[64] Where there has been a resolution of the board to petition to wind-up, the decision may be carried out by any one of the directors who has authority to carry out the decision on behalf of all the directors.[65]

10.4 It is likely that petitions of this kind would be rarely used as directors would be more likely to favour the voluntary winding-up of a company under sections 228 or 228A of the Ordinance. We would, however, note the recommendation that section 228A should be abolished.[66] It has been noted, in relation to the Insolvency Act provisions that:

> " *The directors would in any case require the authorisation of a general meeting in order to be entitled to present a petition for winding-up,*

61 See sub-section (1)(a) and (c) respectively.
62 See sub-section (1)(d) and (e) and sections 147(2)(a) and 177(1)(c) and (2).
63 *Re Emmadart Ltd.* [1979] Ch. 540.
64 *Re Instrumentation Electrical Services Ltd.* (1988) 4 BCC 301.
65 *Re Equiticorp International plc* [1989] 4 BCC 310.
66 See paragraph 15.15.

unless such a power is expressly conferred on the directors by the company's articles. The fact that the articles usually delegate the management of the company to the directors has been held[67] *not to include an authorisation to present a winding-up petition without the sanction of a general meeting, and it is significant that* [article 82] *of Table A does not confer any such authority*" .[68]

10.5 We are aware that due to the nature of Hong Kong companies, where family interests are probably more prevalent than in other jurisdictions, there could be a danger of family groupings oppressing the interests of minorities. We have, however, never considered that the existence of family interests in companies should be given any special weight.

10.6 We **recommend** that directors, following an ordinary resolution of the board of directors, should be able to petition to wind-up their company without the need to obtain the approval of a general meeting of shareholders. Shareholders would be able to express their opposition at the hearing of the petition. Situations may arise where directors have to act urgently to have their company wound-up by the court and the danger of oppression of minorities is counterbalanced by the recommendation that only recognised insolvency practitioners should be qualified to act as liquidators in a winding-up by the court.[69] We consider that the need to wind-up a company in urgent circumstances could only arise in situations where a company was insolvent and we **recommend** that directors should only be able to wind-up companies under such circumstances.

10.7 These recommendations modify the proposal in the *Consultation Paper*.[70] We received submissions expressing reservations about the effect on shareholders and representing that it was important that the shareholders had an opportunity to make their views known before a final decision was taken on the future of their company and that for the present purposes, shareholders should not be reduced to trying to oppose a petition in the court.

Telephone and fax numbers and e-mail addresses to appear on a petition

10.8 The information to be given in a statutory demand under Insolvency Act, rule 4.6, provides that the address and telephone number of an individual who may be contacted by the debtor with a view to satisfying the debt must be given. Similarly, the notice of appearance on the hearing of a petition under Insolvency Act, rule 4.16, provides that the notice should contain the name and address of any person giving it, together with his phone number.

10.9 We would go further and **recommend** that any notice under the insolvency provisions which requires any form of reply, including statutory demands and petitions, should contain full details of how to contact the person giving the notice, or the details of his representative. We **recommend** that in addition to the address and telephone number of the contact party, other details such as fax number and e-

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67 *Re Emmadart Ltd.* [1979] Ch. 540, paragraph 10.2.

68 See *The Law of Insolvency,* Ian F. Fletcher, 2nd edition, page 534.

69 See generally Chapter 3.

70 See paragraphs 5.2 to 5.6 of the *Consultation Paper*.

mail address may also be included. The guidance notes on all such notices should reflect this.

Advertising the petition in the Hong Kong Government Gazette

10.10 We note the general comments on the advertising of notices relating to the winding-up provisions in the Government Gazette.[71]

Inconsistency between section 179(2) and section 257

10.11 We note an inconsistency between these two provisions. Section 257 provides that where a company is being wound-up voluntarily, any creditor may apply to have the company wound-up by the court, but that if the application is submitted by a contributory, the court must be satisfied that the rights of the contributories will be prejudiced by a voluntary winding-up. Under section 179(2) the court must be satisfied that the voluntary winding-up cannot be continued with due regard to the interests of the creditors and contributories.

Section 180 Powers of court on hearing petition

Contributories

10.12 It has been generally accepted in Hong Kong that it is not necessary, where a contributory petitions under section 180(1A) that it is just and equitable that a company be wound-up, for the contributory to prove that the company has a surplus available for distribution from which the contributory could ultimately benefit.[72]

10.13 That is not the case in the United Kingdom where it has been bng established that a petitioning contributory must show that that he has a tangible interest in the company.[73]

10.14 The Hong Kong provision and the equivalent provision under the Insolvency Act, section 125(2), are similarly worded and it is unclear that a different approach has been taken to the petitions of contributories.

10.15 The *Consultation Paper* proposed that the Hong Kong provisions should be amended to make it clear that a contributory should not have to prove that he had a tangible interest in the company against which the petition had been made and noted section 467(5) of the Australian Corporations Law in this regard.[74]

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71 See *Chapter* 29.

72 *Re DJH Consultants Ltd. and Others,* (1984) Civil App No. 164, *Re Cirtex Co Ltd.*, [1987] 3 HKC 13, *Re Yick Fung Estates Ltd.* and *Re Shui Hing Investment Co. Ltd.* CWU Nos. 100 and 101 of 1984 reported as *Waychong Enterprises Ltd. and anor. v Yick Fung Estates Ltd.*(1985) HC No. 4298 of 1983, see [1986] HKLR 240, CA, and note also *Re Universal Information Ltd.* (1995) CWU No. 187 of 1995.

73 *Re Rica Gold Washing Co.* (1879) 11 Ch. D. 36, at paragraph 8.4.

74 Note the recommendation under section 170 on expanded circumstances where a contributory can present a petition at paragraphs 8.4 to 8.6.

10.16 We received two submissions which questioned why a contributory should be entitled to petition if he had no tangible interest in the company, with the thought that such a petition would seem likely to be motivated by improper reasons. It was also submitted that it was a policy issue and not a matter for the court. In the case of a petition by a contributory, the English practice of requiring the contributory to show that he has a tangible interest in the company, that is the company has a surplus available for distribution from which the contributory could benefit, before he can present a petition, is a sound rule.

10.17 We take these points and change the proposal to **recommend** that a petitioning contributory should establish that he has a tangible interest in the company.

Section 180A Hearing of unopposed petition by Registrar of High Court

10.18 In the case of an unopposed petition, the jurisdiction of the court may be exercised by the Registrar of the High Court.

Petition not opposed unless affidavit in opposition filed

10.19 It has been suggested that there might be a practical problem with the section in that it is sometimes very difficult to know whether a petition has in fact been opposed or not. Experience suggests that appellate decisions as to what is meant by opposition tend to be lenient in favour of companies being petitioned against.[75]

10.20 This means that the petitioner' s solicitors can get caught in a situation where the company petitioned against has done no more than indicate that the company wants to settle the dispute but a Registrar proceeds and makes an order for winding-up which is later set aside on appeal on the ground that the Registrar does not have the jurisdiction to wind-up a company where there is opposition to the petition.

10.21 It was suggested that there might be a problem in that a Registrar could hear unopposed petitions but that, if there was even remote opposition to the petition, the hearing had to be adjourned before a judge. It was felt that there was a problem judicially in a Registrar adjourning, for example, a case for two weeks with costs to the Official Receiver, because a Registrar could only deal with unopposed petitions. He had no substantive jurisdiction. We consider that there is an argument for allowing Registrars to have slightly increased powers.

10.22 An example of the point in question occurred in the case of *Hendrarsin and ors v Chong Lai Fee and anor*, when the Court of Appeal considered the question of the jurisdiction of the Registrar of the then Supreme Court to wind-up companies on unopposed petitions. In the particular circumstances of the case, it was held that an unequivocal statement of intention to oppose a petition in the notices of intention to appear entered by the contributories, reinforced by what the Registrar had been told

[75] Note that under the Companies (Winding-up) Rules, rules 30 and 32 any person who intends to appear on a petition must give notice of his intention and affidavits in opposition to a petition must also be filed.

about an earlier petition, was clear evidence that the petition was opposed. The fact that the petition was opposed went to the Registrar' s jurisdiction to make a winding-up order. It followed that failure to file an affidavit in opposition or to take out a summons for a stay or apply for an adjournment could not have conferred jurisdiction on the Registrar. The Registrar thus had no power to make the winding-up order.

10.23 Under the Insolvency Act, a Practice Direction lists all the applications that must be heard by the judge. It states that all other applications shall be made to the Registrar in the first instance, who may give any necessary directions and may, in the exercise of his discretion, either hear and determine it himself or refer it to the judge.[76]

10.24 We **recommend** that the Registrar should be able to make a winding-up order in an unopposed case and that a petition should not be regarded as opposed unless an affidavit in opposition has been filed by or on behalf of the company. The Registrar should also be given authority to deal with all matters relating to filing and service of affidavits, including extensions of time. In practice, the court may in complex cases give extensions of up to five weeks for the filing of affidavits.

Section 181 Power to stay or restrain proceedings against company

10.25 The section allows the company, any creditor, or a contributory, to apply to the relevant court to stay or restrain proceedings that are pending against the company. The court may stay or restrain any proceedings on such terms as it thinks fit.

Not to apply to section 166

10.26 The provision applies, however, only after the presentation of the petition and before a winding-up order has been made. The Bar Association made a submission on the *Consultation Paper on Corporate Rescue and Insolvent Trading* to the effect that section 181 might be extended to facilitate a moratorium under section 166, which provided companies with the power to compromise with creditors and members. The difficulty with section 166 is that there is no means by which a company seeking to compromise can be protected from actions of creditors or members to frustrate the compromise, such as a petition to wind-up the company.

10.27 The Bar Association submitted that section 166 might be used both before and after winding-up and that neither the presentation of the petition nor an order made upon it would, as a matter of law, finally end the possibility of a scheme for voluntary arrangement. 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, would be an effective period of time in which a scheme for voluntary arrangement could be finalised.

10.28 In addition, once a petition was presented, the court would have the power to grant a stay of proceedings or execution where a scheme could be finalised.

[76] Practice Direction No. 3 of 1986 (United Kingdom).

The submission concluded that if the lack of a moratorium was considered to be a major defect, consideration could be given to extending application of section 181 to pre-presentation situations.

10.29 The *Report on Corporate Rescue and Insolvent Trading* rejected the suggestion for a variety of reasons, including points made that section 166 was an open-ended procedure which was not desirable, that use of section 166 could result in limitless court applications, and that section 166 had no proper procedural structure on which to process a workout. Ultimately, however, the *Report* considered that the recommendations for provisional supervision would render use of section 166 redundant.[77] We remain of the view that there is no reason to extend the application of section 181 to the period before the presentation of the petition.

Section 182 Avoidance of dispositions of property, &c. after commencement of winding-up[78]

Lites pendentes in winding-up by court to be registered by Official Receiver

10.30 Prior to the publication of the *Consultation Paper,* Mrs. J. C. Olivier, then of the Legal Aid Department submitted that:

> " *To enable petitions to be registered as lites pendantes: In relation to the existing winding-up provisions, I would like to see the introduction of an explicit statutory provision to enable ' winding-up petitions' to be registered in appropriate land registers as lites pendantes, where land property or interest therein forms part of the assets of a debtor company. Such registration would provide for early protection of assets and be of great assistance to this Department.*
>
> *I would emphasise the word ' statutory' . I am at present of the opinion that such a power can be inferred from the provisions of the Land Registration Ordinance but this opinion is not shared by the Land Registrar who refuses to accept winding-up petitions as lites pendantes on the general premise that as a rule there is no reference to land etc. in the body of a petition and accordingly in his opinion there is no compliance with the interpretation of lites pendantes in section 1A of the Land Registration Ordinance.*
>
> *The interpretation of lites pendantes in section 1A is :*
>
> > *(a) any action or proceeding in a court or tribunal that relates to land or an interest in or charge on land; and*
> >
> > *(b) a bankruptcy petition.*
>
> *You will note the anomaly between winding-up and bankruptcy procedure. As a rule a bankruptcy petition also does not refer to land*

77 See the *Report on Corporate Rescue and Insolvent Trading*, October 1996, paragraphs 1.1 to 1.7.

78 Note the comment on sections 182, 183 and 186 at paragraphs 14.22 to 14.24.

etc. therein but same is specifically included in the interpretation of lites pendantes.

My research on this issue does indicate that in the late 19th & early 20th century, the companies legislation in England provided for such registration of winding-up petitions but the statute law developed since has ' lost' this provision. Indeed it is interesting to note that winding-up petitions are considered lites pendantes in certain states of Australia, with mandatory registration, as it is also in Malaysia and Singapore."

10.31 The *Consultation Paper* indicated that it did not intend to arbitrate in the dispute as to whether a winding-up petition was a *lis pendens* as defined under the Land Registration Ordinance (Cap. 128). The *Consultation Paper* expressed uncertainty as to whether a winding-up petition should be registrable as winding-up proceedings were not an *in rem* claim since they did not relate to the title or status of property. The *Consultation Paper* stated that winding-up proceedings only related to the status of the company being petitioned against.

10.32 The *Consultation Paper* considered that, in any event, there were already adequate facilities for searches against winding-up petitions, as a search against a petition could be made in both the Official Receiver's Office and in the High Court Registry. The *Consultation Paper* pointed out that the Official Receiver's Office kept a computer record of all petitions filed and that the High Court Registry would be computerised in late 1998.

10.33 We received three submissions in support of the original submission of Mrs. Olivier and we are persuaded to **recommend** that *lites pendentes* in windings-up by the court should be registered in the Land Registry as a matter of course.

10.34 To give effect to this, we **recommend** that the Official Receiver, as recipient of copies of all bankruptcy petitions and petitions for winding-up by the court, should be obliged to register these petitions in the Land Registry. We understand that this recommendation would broadly follow the position in England and Wales where a petitioner can register a petition in the Land Registry under the Land Charges Act and with the Official Receiver.

Section 183 Avoidance of attachments, &c.

10.35 The section provides apparently strict wording that any attachment, sequestration, distress or execution against the estate of the company after the commencement of the winding-up " *shall be void to all intents*" . The actual position is not so strict, however, as sections 181 and 186 provide the court with a discretion to allow proceedings to continue if the court thinks fit. Also, section 269 restricts the rights of creditors in relation to attachment or execution in cases where a company has been wound-up.

10.36 There was a suggestion in the Insolvency Sub-committee that the strict wording of the section should be amended to reflect the actual situation but we note that the same wording is used in the United Kingdom, Australia and Singapore and we consider that it would be best that Hong Kong should remain in step with these jurisdictions.[79]

Section 186 Actions stayed on winding-up order

10.37 The section provides that where a winding-up order has been made, or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company except by leave of the court, and subject to such terms as the court may impose. We refer to the comments on this section under section 209A.[80]

Section to apply to creditors' (insolvent) voluntary winding-up

10.38 We received a submission that the principles of sections 183 and 186 should be applied to a creditors' (insolvent) voluntary winding-up in that the *pari passu* principle and the concept that claims should be dealt with in the proof procedure should apply. The submission noted that it appeared that section 186 was already applied to voluntary windings-up on an application under section 255, the burden being on the liquidator to satisfy the court on why the stay should be granted. The submission considered that it would be preferable to have an automatic stay of proceedings in a creditors' (insolvent) voluntary winding-up, and for a claimant to be able to apply to the court to uplift the stay for a good reason. We support this submission and **recommend** its adoption.

Quasi-judicial actions, quasi-criminal actions and administrative actions

10.39 A submission was received as to whether quasi-judicial actions, such as arbitration, quasi-criminal actions such as offences under the Companies Ordinance, Import and Export Ordinance (Cap. 60) and administrative actions such as those taken by the Trade Department against traders who breached any of the provisions of the textile control system, were caught by this section and whether assets affected by these actions were available to creditors.

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79 United Kingdom Insolvency Act, section 128(1), the Australian Corporations Law, section 468(4), and the Singapore Companies Act, section 260.

80 See paragraphs 14.22 to 14.24.

10.40 We have heard of no such problems. As regards arbitration proceedings we are of the view that they are unlikely to proceed once winding-up proceedings have been instituted and insolvency practitioners on the Insolvency Sub-committee have had no problems with arbitrations. We note that section 5 of the Arbitration Ordinance (Cap. 341) makes some provision for bankruptcy but appears to make no provision for winding-up. For the avoidance of doubt, we **recommend** that provision should be made in the Companies Ordinance that an arbitration clause in a contract should not, in the absence of substantial dispute, be sufficient to preclude a right of a petitioner to petition to wind-up a company.

10.41 We note the decision in *Hollmet AG & Another v Meridian Success Metal Supplies Ltd* [81] where the court held that it was the underlying contract, not the winding-up proceedings, that was the subject matter of an arbitration agreement and that the court' s jurisdiction was not ousted merely because a contract provided that disputes should go to arbitration. It may be noted that the court added that once arbitration proceedings had been commenced the matter was different because it might then be said that there was not a debt owing.

10.42 As regards fines and penalties under the Companies Ordinance and other Ordinances, we note that the *Report on Bankruptcy* recommended that fines were not provable by the Government.[82]

Right to sell quota

10.43 We were advised by the Trade Department that a liquidator or receiver appointed by the court was allowed to dispose of the existing quota of a company but that the liquidator or receiver could accept allocation of new quotas on behalf of the company.[83]

81 [1997] HKLRD 828.

82 See the *Report on Bankruptcy*, paragraphs 15.29 to 15.49 and section 34(3A) of the Bankruptcy Ordinance.

83 There will be no restrictions on exports of textile products by 2004.

Chapter 11 - Official Receiver in Winding-up

Section 190 Statement of company's affairs to be submitted to Official Receiver[84]

11.1 This section makes provision for the preparation and submission to the Official Receiver of a statement of affairs once the court has made a winding-up order or appointed a provisional liquidator. The court may order that no statement of affairs is required. The statement of affairs is in prescribed form[85] and it must contain details of all assets, liabilities, and securities and details of the company's creditors. The Official Receiver may require other information.[86]

11.2 The statement must be verified by affidavit by at least one of the directors or the secretary of the company at the time the company is wound-up or by, among others, former directors or officers or employees of the company.[87]

11.3 The statement should be submitted within 28 days of the relevant date,[88] but the time may be extended by the Official Receiver or the court. The reasonable costs of those who prepare the statement shall be paid out of the assets of the company.[89]

11.4 The statement of affairs may be used in evidence against any person making or concurring in the making of the statement. Any creditor or contributory may, on paying a fee, inspect and copy the statement of affairs.[90]

Valuation of assets by directors

11.5 We received a submission which questioned whether any real benefit was to be obtained from that part of the statement which required directors to estimate asset values. The point made is reasonable but we favour the retention of the obligation even though experience suggests that directors tend to produce diverse valuations of assets. The requirement should be retained because it provides a good reference point for the statement of affairs and it has the effect of making directors think about the situation they and their company are in.

84 Note also the Companies (Winding-up) Rules, rules 39 to 44.
85 See form 23 of the Companies (Winding-up) Rules.
86 Sub-section (1).
87 Sub-section (2).
88 "*Relevant date*" for the purposes of this section means, in a case where a provisional liquidator has been appointed, the date of his appointment, and where no provisional liquidator has been appointed, the date of the winding-up order, per sub-section (8).
89 Sub-sections (3) and (4).
90 Sub-sections (5A) and (6).

Costs of preparation of statement of affairs

11.6 Another submission questioned whether the provisions of the Companies (Winding-up) Rules, rule 43, and section 190(4) were consistent. Section 190(4) provides that any person who makes the statement of affairs shall be allowed out of the assets of the company such costs and expenses incurred in preparing and making the statement of affairs as the Official Receiver may consider reasonable, subject to an appeal to the court.

11.7 The oddly worded rule 43 provides that no person shall be allowed out of the assets of the company any costs or expenses which have not, before being incurred, been sanctioned by the Official Receiver, subject to any order of the court.

11.8 Whatever the differences are we consider that there is no need for two provisions to cover the same situation and we **recommend** that they should be combined.

11.9 We **recommend** that the costs of the preparation of the statement of affairs should not be paid by the company as a matter of course. The onus should be placed on those obliged to prepare a statement of affairs to demonstrate to the Official Receiver or the provisional liquidator that any costs to be incurred in the preparation of the statement of affairs relate to work that would not have been done by the company as a matter of course in bringing the books of the company up to date.

11.10 By this we mean that if the books and affairs of a company have been neglected to such an extent that it would require a greater outlay than would have resulted from the preparation of a statement of affairs by a company that kept its affairs and books in order, the extra costs of preparation of the statement of affairs should be borne by those obliged to prepare the statement of affairs. On the assumption that the books were correct, these costs would be limited to the costs of extracting relevant information from the books. In any event, the costs of preparation should not be a burden on the company as a matter of course.

Extension of date for submission of the statement of affairs

11.11 A submission was made that a private sector liquidator should have the power to extend the date for submission of the statement of affairs as well as the Official Receiver when a private sector liquidator had been appointed provisional liquidator. We do not support the submission as the Official Receiver is the person who prosecutes offences where no statement of affairs is produced and, as a consequence, should have control of the process.

28 days for submission of the statement of affairs

11.12 In the *Report on Bankruptcy*, the Commission recommended that the time for the submission of the statement of affairs should be increased from seven to 21 days on creditors' petitions. This recommendation was adopted in the Bankruptcy (Amendment) Ordinance 1996, section 12. The question arises whether the Companies Ordinance provision should be amended to reflect the bankruptcy position.

11.13 We consider that there is a considerable difference between the statement of affairs of a bankrupt and of a company. In general, companies' statements are more complicated and therefore we are content that the current provision should remain at 28 days for submission, subject to the power of the Official Receiver or the court to extend the time in appropriate cases.

11.14 We would add that where the liquidation of a company involves the unwinding of complex financial contracts, the usual rules regarding the preparation of a statement of affairs within the stipulated period may be frustrated and it may be appropriate to make provision for such an event in the winding-up provisions.

Dispensing with the statement of affairs

11.15 Section 190(1) provides that the court may dispense with the statement of affairs and rule 44 provides that any application to dispense with a statement of affairs must be supported by a report of the Official Receiver. It is necessary to have a provision to facilitate dispensing with the statement in a winding-up by the court, because, unlike voluntary winding-up, situations are likely to arise in winding-up by the court, such as the unavailability of the directors or of the books of account, which would prevent the preparation of a statement.

11.16 Although the preparation of a statement of affairs is just as important in a receivership as it is in a liquidation, there is no statutory requirement that the directors produce a statement to a receiver. We suggest that the position can be relaxed in the case of winding-up by the court.

11.17 We consider that the Official Receiver would not report that the statement of affairs should be dispensed with in cases where there clearly should be a statement of affairs prepared. We **recommend** that the Official Receiver should have the discretion to dispense with the statement of affairs without having to apply to the court and without having to show specific grounds. This follows a provision under the Insolvency Act, section 131(5)(a).

11.18 In cases where a private sector liquidator has been appointed, we **recommend** that the Official Receiver should have the same discretion to dispense with the statement of affairs without the need to apply to the court.

11.19 The adoption of these recommendations would have the benefit of reducing costs in some liquidations.

Contempt of court

11.20 Under the Insolvency Act, section 288(4), which provides for a statement of affairs to be submitted in cases of personal bankruptcy, a bankrupt may be guilty of a contempt of court if he fails, without reasonable excuse, to submit a properly completed statement of affairs to the Official Receiver. Adoption of this provision was recommended by the Commission in the *Report on Bankruptcy* and is now contained in section 12 of the Bankruptcy (Amendment) Ordinance 1996. This provision has not been applied to the Insolvency Act provisions for statements of affairs in cases of companies.

11.21 The preparation of the statement of affairs is one of the most important aspects of the winding-up of a company as it enables the liquidator not only to establish the assets, liabilities and creditors of the company, it also provides the basis for the liquidator or the Official Receiver to investigate any wrong-doing on the part of the company or its directors.

11.22 To that end, directors, in particular, should be encouraged to prepare a statement of affairs as quickly as is reasonable in a particular case. This, however, does not always happen, and, in practice, directors often seek to delay the preparation of the statement. It is common for it to take months of encouragement before directors produce a statement and the practitioners on the Insolvency Sub-committee are convinced that in numerous cases directors are not intimidated by the prospect of a fine. The figures show that, although fines are imposed, they are usually small.[91]

11.23 We **recommend** that, in addition to the provisions for fines, it should be a contempt of court for a director to fail, without reasonable excuse, to produce a statement of affairs to the Official Receiver within 28 days of the relevant date or such extended period as the Official Receiver may allow. There was a submission that provisions should be made to permit an application to the court for time if it was refused by the Official Receiver. We consider that this would be unnecessary as the court would take account of all the circumstances of a case in any contempt proceedings.

No exemption for non-executive directors in respect of the statement of affairs

11.24 We received a submission that non-executive directors might find it impossible to produce a statement of affairs which they believed to be true and fair, in the absence of the assistance of executive directors and that, therefore, it would seem fair to confine the charge of contempt of court to executive directors only.

11.25 In the *Report on Corporate Rescue and Insolvent Trading*, the Commission made recommendations that directors and senior management should be open to liability for insolvent trading. It was recommended that any provision on insolvent trading should define directors in sufficiently broad terms to include those who hold themselves out as directors. The *Report* also commented on the position of non-executive directors and stated that anyone who accepts a directorship of a company has an obligation to ensure that that he is kept informed of the financial position of the company. The *Report* added, however, that if directors and others had been deliberately misled as to the financial position of the company by other directors or senior management, they should not be held responsible for insolvent trading.[92]

11.26 We **recommend** that the same provision should apply to the winding-up provisions. This should serve to satisfy the concerns expressed in the submissions but we would caution that the recommendations on connected person and associates should indicate that we have little time for those non-executive directors who are prepared to lend their names as directors and take the money but who are not prepared to keep themselves informed of the financial position of the company.

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[91] See *Fines and imprisonment* , at paragraphs 11.28 to 11.30.

[92] *Report on Corporate Rescue and Insolvent Trading*, paragraphs 19.15 to 19.26.

Fines and imprisonment[93]

11.27 If a person who is required to produce a statement of affairs makes default without reasonable excuse in complying with the requirement, he may be subject to a fine on summary conviction of up to $50,000 and a daily default fine of $300.

11.28 There is no provision under the Companies Ordinance for the imprisonment of such persons for failure to produce a statement, though there is precedent for this under the Singapore Companies Act, section 271(5), which provides for a fine and imprisonment for up to 12 months. The adoption of the recommendation that directors may be in contempt of court for not producing a statement of affairs would mean that directors could be imprisoned as a consequence of such a contempt.

11.29 The *Official Receiver's Office Annual Departmental Report for 1996/97* records that, during that period, 40 cases were brought to hearing before the court and that 25 of the cases resulted in convictions.[94]

Affidavit of concurrence

11.30 The Insolvency Act, rule 4.33, provides that the Official Receiver may require any person who may be required to submit a statement of affairs to submit an affidavit of concurrence stating that he concurs in the statement of affairs. The affidavit of concurrence may be qualified in respect of matters dealt with in the statement where the maker of the affidavit is not in agreement with the deponents, or he considers the statement to be erroneous or misleading, or he is without the direct knowledge necessary for concurring in the statement.

11.31 We **recommend** the adoption of such a provision as it is unfair to expect a person who disagrees with a statement of affairs, in whole or in part, to be obliged to swear as to its accuracy and truthfulness when he cannot honestly do so. The adoption of this provision might also encourage those who disagree with a statement to say so, as this could assist the liquidator in his investigations.

Section 191 Report by Official Receiver

11.32 The section provides that as soon as practical after a statement of affairs has been submitted, or where the court orders that no statement should be submitted, the Official Receiver shall report to the court on the amount of the company's capital issued, subscribed and paid up, the estimated amount of the assets and liabilities, the causes of failure of the company, and whether the Official Receiver considers any further inquiry is desirable.

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[93] Sub-section (5) and see the Twelfth Schedule of the Companies Ordinance. Note also L. N. 306 of 1996 which increased the levels of fines under the Companies Ordinance.

[94] Annex 15 of the *Official Receiver's Office Annual Departmental Report* 1996/97. Note that there were 11 disqualifications from acting as a company director in 1996/97 according to Annex 16 of the *Official Receiver's Office Annual Departmental Report*.

11.33 If the Official Receiver considers that any fraud has been committed in relation to the company he should report to that effect, in which case the court has available the powers provided under section 222.

Official Receiver to have discretion to file report

11.34 The Official Receiver' s Office submitted that, in practical terms, the section as it was established served no useful purpose. The submission stated that the original expectation of the section was that a statement of affairs would be produced at an early stage in a liquidation and the Official Receiver could then make a preliminary report setting out the details mentioned above. In practice, however, the report was made at a much later stage of the liquidation, when its value was questionable.

11.35 The Official Receiver' s Office referred with approval to section 132 of the Insolvency Act, which replaced an original provision similar to the current provision in the Companies Ordinance with one which provided that the Official Receiver had a discretion to report on the reasons for the failure of a company and as to generally, the promotion, formation, business, dealings and affairs of the company. The Official Receiver was under a duty, however, to investigate these matters even though he might not make a report.

11.36 We **recommend** that the Official Receiver' s Office' s submission should be adopted. We see no sense in continuing with a provision that the Official Receiver' s Office points out is of little use in practice and which amounts to an unnecessary expense in many liquidations

No obligation on Official Receiver to investigate if company has not failed

11.37 The *Consultation Paper* noted comment on the Insolvency Act provision which found it surprising that the Official Receiver in England and Wales should be under a duty to investigate the general features of promotion, formation, business, dealings and affairs of the company as there were circumstances under section 122(1) of the Insolvency Act where the company had not failed, and was being wound-up for other reasons, and, in any event, there would not necessarily be any connection with irregularity.[95]

11.38 We can see no reason why the Official Receiver should be obliged to investigate these general matters if the company has not failed but has been wound-up on other grounds and we **recommend** that any new provision should reflect this.

11.39 We note that section 132(2) of the Insolvency Act provides that the report is, in any proceedings, *prima facie* evidence of the facts stated in it. We **recommend** that this approach should be adopted in any new provision in the Companies Ordinance. We note that the report, if made, could have significance if it points to any wrong-doing by directors and others in cases brought under the provisions on disqualification of directors under Part IVA of the Companies Ordinance

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[95] Under section 122(1) of the Insolvency Act or its equivalent under the Companies Ordinance, section 177(1). See *The Annotated Guide to the Insolvency Legislation*, L. S. Sealy and David Milman, 4th Edition, page 177.

or under, for example, the recommendation for personal liability of directors and senior management for insolvent trading in the *Report on Corporate Rescue and Insolvent Trading*.[96]

11.40 The liquidator' s report could also have significance in other matters such as proceedings in which application is made for setting aside transactions at an undervalue, extortionate credit transactions and the prosecution of criminal offences under the Companies Ordinance.

Official Receiver should make investigations where appropriate in all winding-up cases

11.41 A submission of the Hong Kong Association of Banks suggested that there was, in appropriate cases, a need to conduct an investigation to expose malpractice with a view to eventual prosecution and that such investigations had to be a matter for the Government whereas private sector liquidators should focus on the realization and distribution of assets. The submission added that such investigations should not be funded from an insolvent company' s assets on the basis that it had never been accepted that the victim paid for the investigation of the crime. The submission concluded that the creditors of the insolvent company, who stood to suffer a loss, should not be made to see their dividends further diminished by the cost of an investigation and that it was desirable for these principles to be applied to the other relevant provisions.

11.42 We support this submission and **recommend** that while the Official Receiver should not be obliged to report on inconsequential matters, there is a public interest in the Official Receiver investigating matters where there might have been malpractice by directors or others. This recommendation should be read in conjunction with the comments on the role of the Official Receiver' s Office.[97]

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96 *Report on Corporate Rescue and Insolvent Trading*, Chapter 19.

97 See, generally, Chapter 5.

Chapter 12 - Interim Liquidator, Provisional Liquidator and Liquidator

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Section 193 Appointment and powers of provisional liquidator[98]

Appointment of provisional liquidator

12.1 The section provides for the appointment by the court of a provisional liquidator at any time after the presentation of the petition and either the Official Receiver or "*any other fit person*" may be appointed. The powers of the provisional liquidator are set out by the court order appointing him, with the provision stating that the court "*may limit and restrict*" his powers by the order appointing him. The purpose of a provisional liquidator appointed under this section is to take control of, or preserve, the assets of the company in the period between his appointment and the making of a winding-up order.[99]

12.2 The Singapore Companies Act, section 267, takes a different approach and provides that:

> "*the provisional liquidator shall have and may exercise all the functions and powers of a liquidator, subject to such limitations and restrictions as may be prescribed by the Rules or as the Court may specify in the order appointing him*".

12.3 The Commission is attracted by the idea of providing a standard list of powers for provisional liquidators appointed under this section rather than the current situation under which a provisional liquidator's powers are limited and restricted by the court. We make recommendations on standard powers below. In terms of appointment, we **recommend** adapting the approach of the Singapore provisions to the effect that a provisional liquidator would exercise standard powers subject to the power of the court varying the powers on appointment or on application by the provisional liquidator, as follows:

> "*the provisional liquidator shall have and may exercise all the standard powers set out in the schedule unless the court orders otherwise.*"[100]

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98 Note the recommendation at paragraphs 12.21 to 12.23 that a provisional liquidator appointed under section 193 should in future be known as an "*interim liquidator*", while the provisional liquidator appointed under section 194 would still be known as provisional liquidator. Note also the recommendations under the Companies (Winding-up) Rules, rule 28, at paragraphs 27.6 to 27.8.

99 Sub-sections (1), (2) and (3). See also section 197.

100 One submission suggested that a better wording might be to replace the words after "*schedule*" with "*subject to any extensions, limitations or restrictions which the court may impose*".

12.4 The recommendations on insolvency practitioners would mean that only an insolvency practitioner could be appointed as provisional liquidator.[101]

12.5 It is important to impress that provisional liquidators are appointed to preserve the assets of a company until such time as a liquidator is appointed, when all the powers expressed in section 199 may be exercised. It has been suggested that the only real power that is relevant for a provisional liquidator is the power to preserve assets and that all other powers turn on this power. That might be as good a test of the standard powers as any.

12.6 The standard powers should not be so extensive as to create powers that would be redundant in many cases. We **recommend** that whatever powers are adopted, it should take into account the idea that if a provisional liquidator needs to do anything that is out of the ordinary he should apply to the court for the specific power. This could extend to such matters as sale of perishable goods, be they fresh fish or share warrants.

Specimen powers of provisional liquidators

12.7 Section 193 provides that the court "*may*" restrict the powers of a provisional liquidator and the practice now, as stated, is that the court invariably does. The *Consultation Paper* proposed that the Ordinance should contain standard powers for provisional liquidators which would be set out in a schedule.

12.8 The powers of the provisional liquidator are not set out in the Companies Ordinance, unlike the powers of the liquidator which are set out under section 199. The practice is for the court appointing a provisional liquidator to set out the powers of the provisional liquidator in the order appointing him. The practice of the court in recent times has been to set out basic powers in the order and, if the provisional liquidator needs more powers, he may apply to the court to add them.

12.9 A standard list of powers would facilitate the court by allowing it to concentrate on any exceptional powers that a provisional liquidator might seek. The court should have the power to vary the powers of a provisional liquidator but this should only be done for good reasons.

12.10 We received a number of lengthy submissions on the proposals for a standard list of powers for provisional liquidators and all supported the idea. What is also clear from the submissions is that there are a number of different ideas about the extent of the powers. We have, in any event, taken account of the submissions and as a consequence amended some of the powers proposed in the *Consultation Paper*. We do not pretend to have made more than an honest effort to set out standard powers and we would expect that any standard powers that are introduced will need careful consideration.

> ***"Specimen Powers of Provisional Liquidators****:*
>
> *(1) To take into their possession, custody or control any money, property, books, papers or other moveable or immovable property of every nature and kind in Hong Kong to which the Company is or appears to be entitled (collectively 'Assets') but not to distribute or part with the same save for the exercise of the powers hereunder or until further notice.*

[101] See, generally, Chapter 3.

(2) For the foregoing purposes :

(a) to appoint and engage such agents and employees upon such terms as to remuneration or otherwise and for such periods as the provisional liquidator may deem fit;

(b) to incur and defray from the Assets such fees, expenses, wages and salaries as may be necessary therefor or incidental thereto.

(3) To bring or defend any action or other legal proceedings in the name of the Company.

(4) To demand and receive and give a valid receipt for all debts due or which may fall due to the Company.

(5) To exercise the rights to which a registered holder of any shares, unit trust or bonds included in the Assets entitled to exercise, including, but without prejudice to the generality of the foregoing power, the right to exercise any votes annexed to such shares.

(6) To exercise all rights which the Company may have in relation to any subsidiary companies as may be necessary to obtain control of management of any such subsidiary companies.

(7) To insure the Assets in such sum as he deems fit.

(8) To prove, rank, and claim in the bankruptcy, liquidation or other insolvency procedure of any person, company or entity, for any balance against his or its estate, and to receive dividends in the bankruptcy, liquidation or other insolvency procedure in respect of that balance, as a separate debt due from the bankrupt or insolvent, and rateably with the other creditors.

(9) To represent and act for the Company in all such matters, to vote and take part in the election of trustees, liquidators or other insolvency officer-holders, the making of any composition or scheme of any other company or entity, and any other matters arising therein.

(10) To employ or terminate the employment of such persons, including servants, employees, agents, solicitors and counsel as they deem fit for the exercise of their duties hereunder.

(11) To do all such other things as may be necessary for or conducive to the exercise of the powers aforementioned or any of them.

(12) Liberty to apply to the court."

12.11 We removed the *Consultation Paper* proposal that a liquidator should be able " *to carry on or close down the business or businesses of the Company as they shall think fit so far as may be necessary for the beneficial winding-up of the Company*" as a submission pointed out that this might give rise to a concern that, in a given case, the provisional liquidator might make too hasty a judgment to close

down a material part of a company' s business. We accept that the power to close down a business should be a matter for the sanction of the court.

Right of third parties to appear at the hearing of an application for appointment of a provisional liquidator

12.12 The *Consultation Paper* noted a suggestion made in the Insolvency Sub-committee that it might be appropriate to provide that third parties should have standing to be heard by the court at the hearing for the appointment of a provisional liquidator, provided the third party had a proper maintainable interest. At present, only the petitioner is entitled to be heard on the petition. The reason for the suggestion was that the appearance of third parties could help the court to get a clearer picture of the circumstances surrounding the application.

12.13 The *Consultation Paper* was unconvinced that allowing third parties such a privilege would be of much help and it was concerned that such a privilege would only tend to add to the costs. While it was appreciated that the court, in deciding whether it would be necessary to appoint a provisional liquidator, must look at the circumstances of the case and decide whether the matter was sufficiently urgent to justify the appointment of a provisional liquidator, it was felt that the court would be unlikely to be much swayed by further arguments in support of an appointment, and was only likely to be confused as to the issues by arguments against appointment.

12.14 Two submissions supported the idea that third parties should be able to be heard by the court. One submission made the points that the court should be capable of dealing with the arguments put to them by different creditors without being unduly confused and that given the wider powers which it was recommended that a provisional liquidator should have, it could be argued that the court should look in more detail before making an appointment. The other submission made the point that undoubtedly there had been cases in which provisional liquidators had been appointed on the basis of documents which were either deliberately or innocently incorrect and that it seemed wholly improper that other persons should not be able to put the facts straight or be heard in court.

12.15 While acknowledging the truth of these points we take the view that, as one of the submissions acknowledged, the almost inevitable urgency of the appointment of a provisional liquidator and the likely very considerable costs implications of allowing parties to oppose such an application, overrides the ideal of allowing everyone their say in court. We **recommend**, therefore, that third parties should not be entitled to appear in court on an application for appointment of a provisional liquidator.

Section 194 Appointment, style, &c. of liquidators

Liquidator[102]

102 Note also the Companies (Winding-up) Rules, rules 28, 45 to 48, 146 to 155, and 178 to 182.

12.16 The recommendations on insolvency practitioners would have an impact on several of the provisions relating to liquidators and provisional liquidators.[103] Reference is made to these recommendations where appropriate.

12.17 The Insolvency Act contains about 50 rules relating to liquidators dealing with appointment, resignation and removal, release, remuneration, the death of a liquidator and special provisions for the liquidator in a members' (solvent) voluntary winding-up.[104] While a number of these rules are duplicated in the Companies Ordinance we **recommend** that, when and if these recommendations are brought through to legislation, the Insolvency Rules should be considered in detail.

12.18 Some amendments were made to the section in the Companies (Amendment) Ordinance 1997.[105] Sub-section (1)(a) was amended and a new sub-section (aa) was added to provide that where a person other than the Official Receiver was appointed provisional liquidator of a company, he should continue to act as provisional liquidator until he or some other person became the liquidator. Sub-sections (1)(b) and (d) were also amended as a consequence with references to "*Official Receiver*" being replaced by "*provisional liquidator*". The amendments bring section 194 into line with the provisions of section 193.

12.19 These provisions might need to be altered again to allow an insolvency practitioner appointed from the Official Receiver's Administrative Panels to be appointed provisional liquidator so that the appointment of the Panel member could take effect immediately. This would require a new sub-section, possibly sub-section (1)(aaa), to the effect that on a winding-up order being made, the court would appoint the Official Receiver or some other person to be provisional liquidator.

12.20 New sub-sections (2) to (5) have also been added to provide that where the Official Receiver is liquidator of a company, he may apply to the court for the appointment of another person as liquidator in his place. The purpose of these additions is to facilitate the appointment of a private sector liquidator in cases of unexpected realisations of substantial assets. Where a company has assets in excess of $200,000, the case is considered to be non-summary under the terms of section 227F, and the case is contracted out by the Official Receiver to a panel of private sector liquidators appointed under the scheme for contracting out non-summary court winding-up cases to the private sector.[106]

Interim liquidator

12.21 A submission suggested that there should be a third term to describe a liquidator as the term "*provisional liquidator*" was the term used for the person appointed prior to the winding-up order under section 193 and also the person appointed under this section between the making of the winding-up order and the appointment of a "*full*" liquidator by the court. In the first case, "*provisional*" refers to the liquidation but in the second it refers to the nature of the liquidator's appointment. The submission suggested that the term "*statutory liquidator*" could be used to describe the person appointed in the period between the winding-up order and the first meeting of creditors to avoid the use of "*provisional*" and to recognise that the person would either be the Official Receiver or a person approved by the court.

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[103] Note the recommendations on the licensing of insolvency practitioners at Chapter 3.

[104] Insolvency Act, rules 4.100 to 4.150.

[105] Ordinance No. 3 of 1997.

[106] See paragraphs 3.4 to 3.8.

12.22 We generally support the submission and agree with an additional comment made in the submission that the use of the term "*provisional liquidator*" in relation to appointments in the periods before and after the making of a winding-up order is confusing even for practitioners. We consider, however, that the term "*statutory liquidator*" might also be confusing as provisional liquidators appointed under section 193 and provisional liquidators appointed under section 194 are both statutory liquidators. We **recommend** therefore that the term "*interim liquidator*" should be used for an appointment of liquidator in the period prior to the making of a winding-up order under section 193 and that the term "*provisional liquidator*" should only relate to the liquidator appointed under section 194 after the making of a winding-up order and prior to the first meeting of creditors.

12.23 The use of the term "*interim liquidator*" would reflect the use of the word "*interim*" in the appointment of an interim receiver in the period after the presentation of a petition and before the making of a bankruptcy order under section 13 of the Bankruptcy Ordinance.

Liquidator may summon meetings of creditors and contributories Creditors may require a meeting to be held

12.24 We **recommend** that the Official Receiver as liquidator should have a discretion as to whether to summon meetings of creditors and contributories within 12 weeks of his appointment for the purpose of choosing a person to be liquidator of the company in his place but that 25 per cent of the creditors in value should be able to oblige the Official Receiver to call meetings. This would follow provisions under the Insolvency Act, section 136(4) and (5). Currently, section 194(1)(b) provides that the provisional liquidator shall call meetings.

12.25 Where a meeting is requisitioned by creditors, the request should contain a list of creditors, their written concurrence, and a statement of the purposes of the proposed meeting, as provided for under the Insolvency Act, rule 4.57.[107]

Meeting of creditors' choice of liquidator to prevail

12.26 We **recommend** that where there is a difference of view between meetings of creditors and contributories in a winding-up by the court as to who should be appointed liquidator, the view of the creditors should prevail without the need for an application to the court. The current position under sub-section (1)(c) is that, where there is a difference of view, the court shall decide who should act.

12.27 We also **recommend** that this should be subject to the right of contributories to apply to the court within seven days of the nomination by the creditors, if they so wish. This recommendation equates to Insolvency Act, section 139. If, however, the meeting of creditors, or any adjourned meeting, is inquorate the liquidator shall be nominated by the contributories. This follows section 139(3) of the Insolvency Act.

[107] Note that the rule has application to meetings requisitioned by 10 per cent in value of creditors or contributories as the case may be under Insolvency Act, section 168(2), the equivalent of which is section 200(2).

Section 195 Provisions where person other than Official Receiver is appointed liquidator

12.28 The section provides that where someone other than the Official Receiver is appointed liquidator, before he is recognised as such, he must file a notice of appointment with the Registrar of Companies and he must also provide security to the satisfaction of the Official Receiver.[108]

12.29 The question of the amount of security and the way in which security is given is a matter that is under review by the Official Receiver and private sector liquidators. We are content to make no comment as this is a matter best resolved by the parties concerned.

12.30 There is one issue on the question of security on which we feel we should comment. The Companies (Winding-up) Rules, rule 47, makes general provision for how security is to be given by private sector liquidators. The thrust of the provision is that the Official Receiver dictates the terms. We note that sub-rule (e) provides that the cost of furnishing the security by a liquidator or special manager, including premiums he may pay, shall be borne by the liquidator or special manager personally, and shall not be charged against the assets of the company as an expense incurred in the winding-up. This provision dates back to 1929 and appears to have been abolished in other jurisdictions.

12.31 We do not see why this should be the case. We would prefer for the cost of the security to be out in the open and not obscured in a liquidator' s charge out rate or expenses. We **recommend** that the cost of a security bond should be considered to be an expense incurred in the winding-up and should be charged against the assets of the company.[109]

Section 196 General provisions as to liquidators

Separate provision for resignation, removal and remuneration

12.32 The section provides for the resignation, removal and remuneration of liquidators. The concepts of resignation, removal and remuneration are different and we **recommend** that they should be provided for in separate sections.[110]

Resignation of liquidator

12.33 The section simply states that a liquidator may resign. The Companies (Winding-up) Rules, rule 154, provides that a liquidator who wants to resign must summon separate meetings of creditors and contributories to vote on his resignation. If both meetings agree by ordinary resolution that he can resign, the liquidator must file a memorandum of his resignation with the Registrar of Companies and must also notify the Official Receiver, at which point the resignation takes effect.

108 Note the Companies (Winding-up) Rules, rules 47 and 48, in this regard.

109 Note also the comments on professional indemnity insurance and bonding at paragraph 3.26.

110 Note Chapter 4 on remuneration of office-holders.

12.34 If the creditors or the contributories do not agree, the liquidator must report to the Official Receiver and the Official Receiver or the liquidator must then apply to the court for a determination as to whether the resignation should be accepted and on what terms.

12.35 The process is unnecessarily involved. There is no need for a liquidator to go to the expense of calling meetings of creditors and contributories just to discuss his resignation. It is an unnecessary expense for the company.

12.36 We consider that, if the recommendations on insolvency practitioners[111] are accepted, there will be few cases of resignation in any event, and that, as the Official Receiver would be overseeing the scheme, it is only sensible that the application to resign should be made directly to the court, with the Official Receiver making a report on his view of the application. We **recommend** that a liquidator should be able to resign without the need to hold a meeting of creditors but that the liquidator must obtain the approval of the court.

12.37 A submission suggested that a liquidator should be required to prepare a report to the court setting out the reasons for his resignation and either this should be sent to all of the creditors, or a notice of his intention to apply to the court to this effect should be sent to the creditors with the report being available on request at no charge. We consider that there is no need for such a report to be made as the liquidator will already be obliged to obtain the approval of the court.

12.38 Three submissions made the point that the resignation should be advertised in the newspapers. We consider that it would be useful for notice to be given but newspaper advertising is far too expensive a medium to use lightly and we **recommend** instead that a short notice of resignation should be inserted in the Gazette.

Removal of liquidator

12.39 The section provides the court with the power to remove a liquidator on cause being shown. Sections 235A and 252 provide for removal of liquidators in members' (solvent) voluntary winding-up and in both forms of voluntary winding-up respectively.

Section 199 Powers of liquidators

12.40 The powers of a liquidator are divided into those powers which he may only exercise with the sanction of the committee of inspection or the court, and those powers which he may exercise without sanction.[112]

Powers which may require sanction

[111] Note the recommendations on the licensing of insolvency practitioners under Chapter 3.
[112] Sub-sections (1) and (2).

12.41 The Official Receiver's Office submitted that two of the powers for which a liquidator needed sanction, that is, the power to bring and defend any action or other legal proceedings in the name and on behalf of the company, and the power to appoint a solicitor to assist him in the performance of his duties, should no longer require court sanction.[113] The Official Receiver's Office offered no explanation for the submission but we assume that these are powers which are routinely sanctioned and that there would be a saving of costs.

12.42 Under the Singapore Companies Act, section 273(2)(a), a liquidator is empowered to bring and defend proceedings without the sanction of the court. The power to appoint a solicitor still requires sanction. Under the Insolvency Act, the power to bring and defend proceedings requires sanction in a winding-up by the court, but does not require sanction in a voluntary winding-up. The appointment of a solicitor is, however, not classified as a power and a liquidator, who is not the Official Receiver, is only obliged to give notice of the appointment to the committee of inspection, if there is one.[114]

12.43 As regards the power to appoint a solicitor, we again look to the recommendations for the licensing of insolvency practitioners and we re-emphasise the point that the establishment of the panels recommended should eradicate the sort of liquidator who would be prepared to abuse his position. In consequence, we **recommend** that the power to appoint a solicitor should be amended to broadly follow the position under the Insolvency Act to the effect that a liquidator, whether or not he is the Official Receiver, should only be required to give notice to the committee of inspection, if there is one.

12.44 As regards the power to bring or defend proceedings, we find that the messages from other jurisdictions are mixed. We are not sure, however, that a requirement to obtain the sanction of the court is a bad thing as a liquidator who obtains sanction in respect of proceedings could, in the event of criticism of a failed action, point to his having obtained sanction. We consider that a liquidator should still seek sanction of the court or of the committee of inspection to bring or defend any proceedings.

12.45 A submission noted that a point mentioned in paragraph 9.24 of the *Report on Bankruptcy* had not been taken further. The Commission discussed the possibility of attaching the need to obtain sanction to financial limits above which a trustee or liquidator would be required to seek the sanction of the committee of inspection. The Commission considered the fixing of a financial limit above which sanction would be needed or basing the need for sanction on a fraction of the overall value of the estate.

12.46 The submission considered that the point was a valid one and a solution should be found or some improvement made. The submission suggested that consideration might be given to a financial limit, the limit being the higher of either a fixed amount or a fraction. This would rule out small sums in a small estate (which do not exceed the fixed amount) and admit only meaningful amounts in a large estate (which exceed the fraction as well as the smaller fixed amount).

12.47 Apart from the potential solution submitted, the reasons for rejecting the idea given in the *Report on Bankruptcy* remain. A fixed amount could be a major asset in an estate or it could be insignificant depending on the size of the estate. A

113 Sub-section (1)(a) and (c).

114 See, respectively, paragraph 4 of schedule 4, and section 167(2) of the Insolvency Act.

fraction common to all estates could oblige a trustee to seek sanction for trifling amounts in small estates. If the solution submitted proves to be workable, or some refinement of the submission proves effective, we **recommend** that consideration be given to introducing such a provision.

Powers of liquidators to be placed in a schedule

12.48 The powers of liquidators in windings-up by the court under this section are also applied to voluntary windings-up by section 251. The powers of liquidators have been conveniently collected together and tabulated in the fourth schedule to the Insolvency Act.[115] We **recommend** that for ease of reference it would be sensible to place the powers of all liquidators, however appointed, in a schedule to the Ordinance.

Foreign currencies

12.49 The *Report on Bankruptcy* recommended that if a trustee, on taking expert advice, considered that it would be beneficial to the estate to delay the conversion of foreign currency to Hong Kong dollars he should be able to do so but only with the approval of the creditors' committee, or the court in the absence of a creditors' committee (committee of inspection). The *Report* also recommended that a trustee should have the discretion to pay foreign currency claims in the foreign currency.[116]

12.50 The reasoning behind the recommendations was that, as enormous sums of money could be at stake in some insolvencies, it could be of benefit to an estate to allow a trustee some flexibility in dealing with assets in foreign currencies.

12.51 In normal circumstances, a trustee or liquidator should convert a foreign asset into Hong Kong dollars once the asset is realised in a foreign currency. This, of course, is the safe option. Nonetheless, the Commission considered that, while it was not the function of a trustee to engage in currency speculation, the value of an estate could be increased by effecting a conversion at an opportune moment. The *Report* cautioned that trustees should act carefully because a loss on a delayed conversion could leave a trustee open to claims by creditors. The recommendations were adopted in the Bankruptcy (Amendment) Ordinance 1996.[117]

12.52 We consider that the power to delay conversion is even more relevant in the liquidation of companies. This is, perhaps, a matter of some consequence at the present time as there is an economic downturn in the region. In Hong Kong there have been liquidations of companies which were exposed to foreign markets and hence foreign currencies. We **recommend** that liquidators should be provided with the same powers as have been provided to trustees in bankruptcy.

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115 See Insolvency Act, sections 165 and 167, and the 4th Schedule to the Act.

116 *Report on Bankruptcy*, paragraphs 15.11 to 15.16.

117 See the Bankruptcy Ordinance, section 61(k).

Section 200 Exercise and control of liquidator's power

12.53 In its *Report on Bankruptcy* the Commission recommended that a trustee in bankruptcy should be subject to specific statutory duties. These duties were subsequently adopted in the Bankruptcy (Amendment) Ordinance 1996.[118] We **recommend** that these duties should be adapted to apply to liquidators. The duties as set out in the *Report on Bankruptcy*[119] are that:

> *"A trustee should be under a duty to act in a fiduciary capacity and to deal with the property under his control honestly, in good faith, with proper skill and competence and in a reasonable manner.*
>
> *In realising the assets of a bankrupt's estate it should be the duty of a trustee to take all reasonable care to realise the best price reasonably obtainable in the circumstances."*

Disposal of assets of company to members of the committee of inspection

12.54 We received a submission on the disposal of assets to members of the committee of inspection. The submission suggested that the current restriction on committees of inspection dealing in the assets of the company being wound-up, under Companies (Winding-up) Rules, rules 148 and 150, was easily avoided, for example, by setting up a nominee company to purchase the assets and that although a liquidator could go to the court to get approval to override the restriction, this was unnecessarily cumbersome and potentially costly. The submission suggested that consideration be given to granting the liquidator the discretion to decide when a conflict of interests existed in disposing of assets to members of the committee of inspection.

12.55 We are not convinced that any real problem exists in this area. It is not unlikely that a member of a committee of inspection may be the only person interested in purchasing assets of a company on liquidation. We consider that it is appropriate that the liquidator should go to the court to explain the circumstances of such a purchase, at which hearing the only concern of the court should be that the purchase price is reasonable.

Section 202 Payments of liquidator into bank or Treasury

12.56 Liquidators other than the Official Receiver must pay money received by them into the Companies Liquidation Account, which is maintained by the Official

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118 Section 46 of the Bankruptcy (Amendment) Ordinance 1996 amended section 84 of the Bankruptcy Ordinance by providing for additional duties of liquidators.

119 See the *Report on Bankruptcy*, paragraphs 9.32 to 9.37.

Receiver.[120] Where the Official Receiver is liquidator, he is similarly obliged. There is a proviso that the Official Receiver may authorise a liquidator to make his payments into any other bank specified by the committee.[121] A liquidator is prohibited from paying sums received by him as liquidator into his private banking account.[122]

12.57 If a liquidator retains a sum exceeding $2,000 for more than 10 days, he may be subject to repaying the amount so retained in excess at an interest rate of 20 per cent per annum, disallowance of all or such part of his remuneration as the court thinks fit, be removed as liquidator by the court, and be liable to pay any expenses occasioned by reason of his default.[123] We understand from the Official Receiver that private sector liquidators can now retain amounts of up to $20,000 for up to 10 days, which may satisfy the Hong Kong Society of Accountants' submission that the amount should be reviewed.

12.58 The provisions appear to be adequate as, while we have received submissions on other matters relating to the Companies Liquidation Account, we have received no submissions on this section from private sector liquidators.[124]

12.59 We received two submissions that the provision should at the very least be brought into line with the actual practice of allowing a liquidator to hold up to $20,000, or such other amount as the Official Receiver authorised, for up to 10 days. This is logical and we **recommend** its adoption.[125]

12.60 The Official Receiver's Office, however, submitted that the proviso to sub-section (1) was worded in such a way that there had to be a committee of inspection before the Official Receiver could authorise private sector liquidators to have a separate bank account. This result clearly cannot have been intended. We **recommend** that, in sub-section (1), the words "*on the application of the committee of inspection*" should be deleted and the words "*committee of inspection*" should be replaced by the word "*liquidator*".[126]

Section 203 Audit of liquidator's account

12.61 Private sector liquidators are obliged to send an account of receipts and payments every six months to the Official Receiver.[127] The Official Receiver may at any time audit the accounts even if he has exercised his discretion not to audit

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120 See also sections 285 and 293 to 295 and the Companies (Winding-up) Rules, rules 156 and 183.

121 Sub-section (1) and see the Companies (Winding-up) Rules, rule 157.

122 Sub-section (3).

123 Sub-section (2).

124 See the submissions of the Hong Kong Society of Accountants at section 285, paragraphs 23.42 and 23.52.

125 The Companies (Amendment) Bill 1999 proposes replacing the current sub-section (2) with a provision which would allow liquidators retain sums not exceeding $50,000 for 14 days. All other sums should be paid into the Companies Liquidation Account immediately with failure to do so attracting interest on the amount retained at 20 per cent per annum and making the liquidator liable to disallowance of all or part of his remuneration and removal from office by the court. The Bill was gazetted on 19 February 1999.

126 This recommendation is also proposed in the Companies (Amendment) Bill 1999.

127 Sub-section (1) and see the Companies (Winding-up) Rules, rules 162 and 166.

them. The accounts are available for inspection by creditors or other interested parties on payment of a fee.[128]

Accounts under section 203 and section 284 distinguished

12.62 The Hong Kong Society of Accountants submitted that the nature of the forms used in sections 203 and 284 should be standardised. Section 203, however, relates to liquidations by the court, while the provisions on accounts under section 284 have application to voluntary winding-up. Section 203 requires a more detailed form of accounts, for audit purposes, than section 284, which has no audit provision. The main purpose of section 284 is to allow creditors in a voluntary winding-up to check what amounts have been received and paid out.

Summary of accounts

12.63 As regards section 203, the Official Receiver inspects the accounts that are submitted and may audit them. The Official Receiver' s Office confirmed that it sometimes requested further information from liquidators as a result of an audit. As the Official Receiver is looking after the interests of creditors and others we suggest that it is an unnecessary expense to send a summary of the accounts to creditors and contributories every six months.[129] This would accord with a submission made by the Hong Kong Society of Accountants. The accounts at present need to be filed with the Official Receiver and in the court where they are available for inspection.

12.64 We **recommend** that the requirement to send a summary of the accounts every six months should be dispensed with and replaced by a provision which would allow creditors and contributories to obtain a summary on request and for other interested parties to obtain a summary for a reasonable fee.

12.65 A submission suggested that the forms specified by the Official Receiver in relation to liquidators' accounts and, indeed, the insolvency forms generally, should be regularly reviewed and updated. We agree with the submission.

12.66 We understand that, in practice, liquidators have been known to be unwilling to produce a summary on request. We consider that this should not be condoned and **recommend** that, if a liquidator fails to produce a summary within a reasonable time after a request is made, he should be subject to a fine. In the overall context of the recommendations for the regulation of insolvency practitioners, this should be a matter that the Official Receiver, as regulator, would oversee.

Accounts to be filed with the Registrar of Companies

12.67 At present, accounts are filed with both the Official Receiver and the court.[130] Although liquidations that come under this section are under the supervision of the court, we see no reason why accounts should be filed in the court. The *Consultation Paper* proposed, and we now **recommend**, that it would be more

128 Sub-section (3A), (4) and (6).
129 Sub-sections (5) and (6)(b).
130 Sub-sections (4) and (6)(a).

sensible for accounts to be filed with the Registrar of Companies and that provision should be made to replace the references to the court by references to the Registrar of Companies. The Registrar of Companies should be able to charge an inspection fee for this service.

12.68 The Registrar of Companies submitted that it was not necessary that the accounts should be filed with the Companies Registry as section 203 applied to a company which was being wound up by the court and it was only appropriate to require such accounts to be filed with the court so that the court could have a complete record on the winding-up of the company. The Registrar noted that under section 284, which applied to every mode of winding-up, the accounts relating to all kinds of liquidations were required to be filed with the Companies Registry.

12.69 A creditor should be able to inspect the accounts on producing a copy of his proof of debt or, if the recommendations under section 284 are adopted, any person will have the right to inspect a company file. We stand by the recommendation, if only for the reasons that people will have more ready access to a company's file in the Companies Registry than to a court file and for openness in matters relating to the winding-up of companies. The Registrar of Companies, when he made the submission did not have the advantage of knowing the recommendation under section 284 and, indeed, it was the Registrar who raised the question addressed in section 284.[131]

Confidentiality agreements

12.70 A problem could arise with filing of liquidators' accounts in the Companies Registry where a liquidator had entered into a "*confidentiality agreement*" with a purchaser of assets, as the sale price would have to appear in the liquidator's accounts. We **recommend** that this could be overcome by the court agreeing to allow the price to be reported as confidential in the accounts.

Signing accounts by liquidators on conversion of liquidation[132]

12.71 A practical problem may arise in cases where there has been a conversion in the form of winding-up during the 6-month accounting period. Normally the accounts are prepared in the name of the new liquidator but it is unsatisfactory that the new liquidator should have to sign off on another liquidator's accounts. Under the current provisions, a liquidator has to declare that the receipts and payments account is complete when he has not been involved in their preparation at all relevant times.[133] We **recommend** that liquidators should only sign for accounts for the period when they are liquidators.

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[131] Note comment under section 284 in Chapter 23.

[132] This recommendation also relates to accounts prepared under section 284.

[133] For the purposes of section 203, a liquidator signs a trading account, listing receipts and payments under Companies (Winding-up) Rules, rule 163 and form 88. For the purposes of section 284, a liquidator's statement of account is in the form prescribed in form 92, which must be sworn by a liquidator in the form prescribed in form 93.

Section 204 Control of Official Receiver over liquidators

12.72 The section provides that the Official Receiver shall take cognisance of the conduct of liquidators in a winding-up by the court.[134] If a liquidator does not faithfully perform his duties and observe all the requirements imposed on him, or if any complaint is made to the Official Receiver by any creditor or contributory, the Official Receiver is obliged to inquire into the matter and to take appropriate action. The Official Receiver may also require a liquidator to answer any inquiry in relation to a winding-up in which he is engaged and may apply to the court to examine a liquidator or any other person on oath concerning the winding-up. In addition, the Official Receiver may direct an investigation to be made of the books and vouchers of the liquidator.

12.73 The relationship between the Official Receiver and liquidators in both winding-up by the court and in all other forms of insolvency is likely to be affected by the recommendations on the licensing of insolvency practitioners, in which the Official Receiver would play a central role. It is possible that section 204 may be affected by these changes.[135]

Section 205 Release of liquidators

12.74 When a liquidator of a company being wound-up by the court has completed the liquidation and made a final dividend, if any, he may apply to the court for his release. Creditors and other interested persons may object to the release. The court may withhold the release and may make an order charging the liquidator with the consequences of any act or default which he may have made or done contrary to his duty.[136]

12.75 An order releasing the liquidator has the effect of discharging him from any liabilities for acts done or defaults made as liquidator but the order may be revoked on proof that it was obtained by fraud or by suppression or concealment of any material fact.[137] A liquidator must give notice to all creditors and contributories of the application.[138]

12.76 The Official Receiver's Office submitted that there should be no necessity for a liquidator to make an application to the court for release in the absence of any objection from the creditors or contributories. Section 205 clearly contemplates release only in circumstances where the private sector liquidator has effectively completed the liquidation and, to that extent, we see no reason, in the absence of an objection by creditors or contributories, as to why the private sector liquidator should go to the expense of a further court application.

12.77 The *Consultation Paper* proposed that, in the absence of such an objection, the release of a private sector liquidator should be capable of being dealt

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[134] Note also the Companies (Winding-up) Rules, rule 189.
[135] Note the recommendations on the licensing of insolvency practitioners under Chapter 3.
[136] Sub-section (1).
[137] Sub-section (3).
[138] Companies (Winding-up) Rules, rule 189(1).

with by the Official Receiver. The liquidator would still be obliged to give notice to creditors and contributories.

12.78 The Official Receiver's Office submitted that in view of the recommendations on licensing of insolvency practitioners, a liquidator should only be required to file a declaration of release with the court, the Registrar of Companies and the Official Receiver in the absence of an objection.

12.79 We accept the submission and **recommend** that a liquidator need only file a declaration of release as set out above. We also **recommend** that, notwithstanding that a liquidator has been released, it should not absolve him from the provisions of section 276, which provides the court with the power to assess damages against a delinquent liquidator.[139]

12.80 We note that the Insolvency Act, rules 4.124(1) and (2), which equate to the Companies (Winding-up) Rules, rule 189(1), provide that a liquidator, before applying for his release, must provide all creditors and contributories with a summary of all receipts and payments. We consider that this practice should continue.

[139] See Insolvency Act, section 174(6), for an equivalent provision.

Chapter 13 - Committee of Inspection[140]

Section 206 Meetings of creditors and contributories to determine whether committee of inspection shall be appointed

13.1 When a winding-up order has been made by the court, the separate meetings of creditors and contributories shall determine:

- whether or not an application should be made to the court for appointing a liquidator in place of the Official Receiver;
- whether or not an application is to be made to the court for the appointment of a committee of inspection to act with the liquidator; and
- if so, who are to be members of the committee.

13.2 The court may make any appointment and order required to give effect to any such determination, and if there is a difference between the determinations of the meetings of the creditors and contributories in respect of these matters the court shall make such order as the court may think fit.

Relationship of liquidator and committee of inspection
Role of committee of inspection

13.3 The *Report on Bankruptcy*[141] recommended that the corresponding provisions of the Bankruptcy Ordinance[142] should be amended to dispense with the supervisory aspect of the committee of inspection over the trustee in bankruptcy and to replace it with the provision that the committee of inspection act with the trustee. This recommendation followed the wording under section 206(1) and we continue to approve of it.

13.4 The Hong Kong Association of Banks, which made an early submission for the purposes of the *Consultation Paper* that greater stress needed to be given to creditors' rights of supervision of a liquidation, responded to the *Consultation Paper* with a submission that in an insolvent liquidation, the estate is administrated primarily for the creditors' benefit, and they are the persons best calculated to look after their own interests.[143] The submission stated that it was

[140] Note generally the Companies (Winding-up) Rules, rules 146 to 155, 161, and 198.

[141] *Report on Bankruptcy*, paragraphs 9.14 to 9.20.

[142] Section 24(1). The Bankruptcy (Amendment) Ordinance 1996, section 15, amended section 24(1) by repealing "*committee of inspection for the purposes of superintending the administration of the bankrupt's property by the trustee*" and substituting "*creditors' committee to act with the trustee*".

[143] Quoting from the *Cork Report*, paragraph 913.

necessary to recognise that a liquidator of an insolvent company was dealing with creditors' money, and it was unacceptable if creditors were denied an effective say in the administration.

13.5 We note, however, a trend internationally to limit the role of the committee of inspection. Section 206(1) provides that the first meetings of creditors and contributories "*shall*" determine whether or not to appoint a liquidator in place of the provisional liquidator and whether or not to appoint a committee of inspection.

13.6 The insolvency regime in the United Kingdom has undergone a considerable change with the introduction of the Insolvency Act. The requirement that all liquidators must be qualified insolvency practitioners is probably part of the justification for now providing that a liquidator may summon meetings of creditors and contributories to appoint a liquidation committee but there is no obligation to do so unless required to do so by one-tenth in value of the company's creditors.[144]

13.7 In Singapore, the position is much the same as under the Insolvency Act, with a liquidator only being obliged to call meetings if requested to do so by any creditor or contributory.[145] In Australia, a liquidator shall only call meetings if requested to do so by a creditor or contributory.[146]

13.8 The manner in which liquidators are appointed in Hong Kong has undergone a change with the establishment in 1996 of the Official Receiver's Administrative Panel of Insolvency Practitioners for the Court Winding-up of Companies. Under this scheme, the Official Receiver has established a Panel from which he appoints private sector liquidators whom he has approved to act as liquidator in what are known as "*non-summary cases*". This scheme is regarded by us as the first step towards establishing a requirement that all liquidators and other insolvency functionaries should be recognised insolvency practitioners.[147]

13.9 Under the scheme, first meetings of creditors and contributories must be called to consider whether an application should be made to the court for the appointment of a liquidator from the panel. If the meetings express no preference, the appointment is made on a roster basis.

13.10 We are concerned that the role of the committee of inspection should not be completely usurped and we have made no recommendation that would change the principle that a committee, when appointed, should act with the liquidator.

13.11 There should be no obligation, however, on the first meeting to consider whether to appoint a committee of inspection and we **recommend** that section 206(1) should be amended to delete the reference to the obligation to determine whether a committee of inspection should be appointed and an alternative provision should be added to provide that, where appropriate, a liquidator may call meetings or request the first meetings to appoint a committee of inspection.

13.12 We received three submissions which expressed reservations about leaving it to the discretion of the liquidator as to whether to call a meeting of creditors.

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144 Insolvency Act, section 141(2).

145 Companies Act, section 277.

146 Corporations Law, section 548(1).

147 Note the recommendations on the licensing of insolvency practitioners at Chapter 3. Note that the Official Receiver's Administrative Panels have now been extended to cover summary cases. See section 227F at paragraphs 14.116 to 14.119 and paragraphs 3.4 to 3.8.

We consider, however, that the reservations expressed are effectively answered as we also **recommend** that provision should be made to provide that a liquidator should be required to call a meeting of creditors at the request of one-fourth in value of the company's creditors. This would mirror the new requirement under section 17B of the Bankruptcy Ordinance.

13.13 We consider that these recommendations strike a balance between the interests of creditors and the efficient administration of estates. We use the word "*efficient*" deliberately because in many cases the initial enthusiasm of creditors on being appointed to a committee of inspection is not maintained, which can lead to practical difficulties in administering estates. The recommendations do not rule out committees of inspection, they only increase the flexibility of administration.

Directors should be obliged to attend meetings of creditors

13.14 There is no provision currently which obliges directors to attend at a meeting of creditors and the *Consultation Paper* did not address the point. We **recommend**, however, that directors of a company being wound-up by the court or in creditors' (insolvent) voluntary winding-up should be obliged to attend at the meeting of creditors if required to do so by the provisional liquidator and be available to comment on the company's affairs and answer questions if necessary. We would not intend that the meeting should turn into an examination of directors, that function comes under section 222, but we consider that directors who could be expected to be in a position to provide information useful to the meeting should be available to answer questions that the provisional liquidator might not be able to answer. Failure to attend at such a meeting on being required should be an offence.

Remuneration of committee of inspection

13.15 We have no enthusiasm for the notion that the members of the committee of inspection should be remunerated. We do not imagine that members could be paid any more than a nominal amount in any event, as other creditors would oppose large payments being made, and we doubt anything less than large payments would prevent members losing interest.

13.16 One submission, which supported in principle the idea that members of the committee of inspection should not be remunerated, also made the point that if there is a major problem with obtaining and retaining representatives to serve on committees, it may be the only practical solution. The submission added that committees perform a service for the benefit of all creditors, both in their capacity as watchdog and, if used in the right way, as additional advisers to the liquidator and that the costs need not be too substantial.

13.17 The submission suggested that if a rate were fixed with some reference to the amounts charged by professional advisers, the actual cost of meetings would be relatively inexpensive (a rate of, say, $2,000 per hour per member). It could be fixed that, say, up to two hours' preparation time for a meeting could be charged where needed. This might also allow a wider use of professional representatives on creditors' committees. In some of the larger international insolvencies in the United States and the United Kingdom in recent years, lawyers have been appointed as advisers to creditors' committees, paid for by the insolvent estate. This has allowed creditors' committees to understand better what was

happening. It has also allowed them to contribute more ideas for the benefit of the administration of the estate and to be more effective in their role of monitoring the way the administration was run. In some cases, both the options of paying members of the committee and paying an advisor for them would be inappropriate. The submission concluded that it would be helpful to give to the court a general power to direct that there should be remuneration paid to committees of inspection or an independent adviser on the application of either the liquidator or the committee. The court could then set a rate of remuneration appropriate to the circumstances.

13.18 We have set out this submission in full because it provides good arguments in favour of remunerating members of committees. Set against this is the risk that committees of inspection could become profit centers for creditors and their representatives. We are mindful of the fact that the same institutional creditors appear time and again in insolvencies. The fact that there is no profit in being appointed to a committee of inspection in itself imposes discipline on the concept of the committee, obliging creditors to consider only whether they are interested in serving, rather than adding the element of getting paid, and none too badly perhaps, on being appointed to a committee. If members were to be paid, who then would monitor their efforts and decide whether they were providing value for money. In an era when cosy relationships are being questioned we prefer to retain at least one function where there is no element of getting paid for the job.

13.19 We **recommend**, however, that members of committees of inspection should be entitled to their reasonable travelling expenses to and from meetings of committees, limited, naturally, to expenses incurred in Hong Kong.

Resolutions by post

13.20 We **recommend** that committees of inspection should be able to function through written resolutions sent by post. This is provided for in a comprehensive provision under the Insolvency Act and the Bankruptcy Ordinance.[148] Under these provisions, resolutions may be sent out by post by the liquidator or a trustee. If a member requires a meeting on the resolution, he has seven business days from the date of posting to act. In the absence of such a request, the resolution is deemed to be passed.

Length of time liquidations can continue

13.21 We do not know how it would be possible to limit the length of time that liquidations can run. Every liquidation is different and difficult proceedings can continue for years through no fault of the parties involved, as, for example, where the company is subject to claims for personal injuries. The Bankruptcy Ordinance now allows for valuation of proofs of debt in respect of actions for tort, subject to a procedure which would allow the court to place a value on the claim.[149]

13.22 It is more likely in the corporate context that companies in liquidation would be subject to long term liquidation. We see no means by which a time limit could be imposed on liquidations. We hope that the establishment of the scheme for appointing insolvency practitioners and the recommendation that only recognised

148 Insolvency Act, rule 4.167, and the Bankruptcy Rules, rule 122ZP.
149 See the Bankruptcy Ordinance, section 34(4) and (7).

insolvency practitioners should be able to act in insolvency proceedings will have the effect of bringing a more professional approach to all liquidations.

The Securities and Futures Commission

13.23 The Securities and Futures Commission (SFC) made a submission prior to the publication of the *Consultation Paper* that:

> " *Section 206 and 207 of the Companies Ordinance provides for the appointment of a committee of inspection, which shall consist of creditors and contributories of the company or persons holding general powers of attorney from them. One of the functions of the [Securities and Futures] Commission is to safeguard the interests of investors in listed companies. It may be appropriate to consider whether the [Securities and Futures] Commission should have an independent, statutory right to be present at a committee of inspection appointed for a troubled listed company, since the [Securities and Futures] Commission can better exercise the above function if it is able to monitor a liquidation in which the interests of investors may be in jeopardy.*"

13.24 The *Consultation Paper* considered that a provision allowing the appointment of a representative of the Securities and Futures Commission to a committee of inspection would alter the composition of a committee, though it was noted that the SFC was not suggesting that it should have a vote. If a listed company was in liquidation, the role of the SFC would surely have shifted from a role of safeguarding the interests of investors to investigating what went wrong.

13.25 It is likely that in the liquidation of a listed company, the investors would have lost their money and would be ranked behind ordinary creditors for the purposes of receiving a dividend. Once any company is in liquidation, the liquidator takes over with the main purpose of recovering assets. The *Consultation Paper* suggested that the SFC's objectives in such a situation would be more concerned with an investigation of the circumstances that led to the liquidation and that these, perhaps conflicting priorities, could lead to friction within the committee and could divert the liquidator's attention from matters that he would prefer to be pursuing.

13.26 The Securities and Futures Commission responded to these comments, noting that the SFC would only seek such representation in a case where it was the petitioner. The SFC pointed out that its function of protecting the interests of investors in listed companies (the minority shareholders) continued, the process of liquidation notwithstanding. Accordingly, there would be no danger of conflicting priorities on the part of the SFC, particularly when the SFC's representative was there to observe and to offer an opinion but not to vote for any course of action. The submission added that the presence of the SFC's representative might be made the subject of an application to the court, in which event, the SFC would have to convince the court that there was value in its participation.

13.27 The SFC made a further submission in the event that their initial submission did not find favour. The SFC would like to be able to have access to the minutes of the committee of inspection in a case where it was the petitioner in the winding up in view of its continuing statutory responsibility. The SFC also invited that consideration be given to a statutory right being accorded to the SFC to have access

to information and materials in the possession of the provisional liquidator and liquidator where the company in liquidation was either a listed company or a company licensed or registered with the SFC, or a holding company of the same. It was submitted that a similar right should be accorded to the Stock Exchange of Hong Kong Limited (for listed companies and corporate members of the Exchange) and the Hong Kong Futures Exchange Limited (for corporate members thereof).

13.28 We maintain the view that the committee of inspection is not the place for the Securities and Futures Commission to protect the interests of creditors. We would not go so far as one submission which stated that the SFC should safeguard the interests of creditors before winding-up and not after but that comment relates to the real reason for rejecting this submission. It is of no consequence that the SFC's representatives would not vote. It would, simply by being on the committee, have a voice and by being present might distract the committee from its main purposes, not to mention that the mere presence of a representative of the SFC on such a committee might enflame the members.

13.29 We also see no good reason for allowing the SFC the right to have access to materials and information in the possession of a provisional liquidator and liquidator.

Section 207 Constitution and proceedings of committee of inspection[150]

Committee of inspection to be renamed "Liquidation Committee"

13.30 The *Report on Bankruptcy* recommended that the committee of inspection in a bankruptcy should be renamed creditors' committee to reflect its composition rather than to reflect its function.[151] Although we are keen to standardise provisions insofar as they relate to different forms of insolvency, we find that it would be inappropriate to duplicate the bankruptcy amendment in a winding-up because sub-section (1) provides that the committee of inspection shall consist of both creditors and contributories. We therefore **recommend** that the name should be amended to "*liquidation committee*" to better reflect the function of the committee to act with a liquidator, rather than to supervise and inspect.

Committee of inspection to act in the best interests of creditors as a whole

13.31 We note the recommendation that the committee should act in the best interests of the creditors as a whole under section 243.[152]

150 Subject to minor differences, these recommendations would apply equally to the committee formed in a creditors' (insolvent) voluntary winding-up under section 243 , at paragraphs 18.13 to 18.19.

151 This recommendation was adopted in the Bankruptcy (Amendment) Ordinance 1996, section 15. See the Bankruptcy Ordinance, section 24.

152 See paragraphs 18.15 to 18.19.

Number of members of the committee

13.32 The *Consultation Paper* proposed that the maximum number of members of the committee should be limited to five in a winding-up by the court and that the minimum number of members of the committee should be three.[153]

13.33 A submission questioned why there should be any limit on the number of members. The proposal was made on the basis that if there was to be a large number of members on a committee it would tend to stifle the decision making process. It has been brought to our attention, however, that in recent large international liquidation it proved necessary to appoint seven members to a committee of inspection. We therefore amend the proposal to **recommend** that the maximum should be seven members. We maintain the view that it is useful to limit the number of members of the committee to discourage talk shops.

Quorum

13.34 We **recommend** that provision should be made for a quorum of two members present or represented, following the Insolvency Act.[154] A submission on this proposal in the *Consultation Paper* suggested that it was unclear how the quorum provision would work as section 207(3) provided for a committee of inspection to be able to act by majority of those present at a meeting, but also required that a majority of the members had to be present for the committee to act. The submission continued that if sub-section (3) was to be repealed the problem would remain of what would happen if the two members present did not agree with one another.

13.35 The submission is quite correct in pointing out the potential for a tied committee if two members are present. The same applies if there are four or six members present and we know of no way of avoiding this possibility short of tossing a coin.

Body corporate to be a member of the committee

13.36 The *Consultation Paper* proposed that a body corporate should be allowed to be a member of a committee of inspection, while noting that it appeared that there was no provision in the Companies Ordinance prohibiting a body corporate from being a member of a committee. One submission suggested that this was already the law. In any event, we **recommend** that the Companies Ordinance should make appropriate provision. We note that the Insolvency Rules, rule 4.152(5) provides that a body corporate may be a member of the committee.

Letters of authority

13.37 The Official Receiver's Office submitted that sub-section (1) should be amended to provide that a member of the committee should be capable of being represented by another person on production of a letter of authority rather than, as provided for at present, a power of attorney. This submission reflects a recommendation in the *Report on Bankruptcy* for an amendment to the Bankruptcy

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153 Insolvency Act, rule 4.152(1)(a).
154 Insolvency Act, rule 4.158.

Ordinance.[155] We endorse the submission and **recommend** its adoption. The Insolvency Act makes the same provision and also provides that although a body corporate may be a member of a committee, a member may not be represented by a body corporate. We **recommend** that this approach be taken.[156]

Meetings only when necessary and agreed

13.38 Sub-section (2) provides that the committee must meet at least once a month. We consider this to be unnecessary as did the Official Receiver's Office in its submission. The Bankruptcy Ordinance was recently amended to provide that meetings should only be held as and when necessary and we **recommend** that this provision be followed.[157]

Voting

13.39 There is no clear provision as to how members of a committee should vote. We **recommend** that each member of the committee should have a single vote. This would follow the provisions of the Insolvency Act.[158]

Section 208 Powers of court where no committee of inspection

13.40 Where there is no committee of inspection, the court may, on the application of the liquidator, do any act and give any permission which the committee could have done or given. In addition, rule 198 provides that where there is no committee of inspection in a winding-up by the court, any functions of the committee of inspection which devolve on the court may, subject to the directions of the court, be exercised by the Official Receiver.

13.41 The effect of the section is to distinguish the provisions of section 199(1) to the effect that the court will only exercise its powers under the section where there is no committee of inspection.

Official Receiver to sanction actions of private sector liquidators where no committee of inspection

13.42 We **recommend** that the Official Receiver should have the authority to sanction actions of private sector liquidators where there is no committee, subject to the right of the liquidator to appeal to the court if the Official Receiver refuses to grant permission. This would effectively make the provisions of rule 198 redundant. We **recommend** that where the Official Receiver acts as liquidator, he should seek the sanction of the court in the usual way.

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155 The provision for a power of attorney under section 24(2) has been repealed by section 15 of the Bankruptcy (Amendment) Ordinance 1996. The Bankruptcy Rules, rule 122ZJ(2) and (3), now provide for representation by letter of authority.

156 Insolvency Act, rule 159(2), (3) and (4).

157 See the Bankruptcy Rules, rule 122ZG.

158 Insolvency Act, rule 4.165. Note also the Bankruptcy Rules, rule 122ZO.

13.43 It is arguable that the recommendation would create a conflict of roles for the Official Receiver in that, on one level he would be acting as liquidator, and on another level he would be giving authority to take actions for which he, when acting in the role, would have to seek authority. This happens anyway, in a number of instances. The Official Receiver is liquidator, supervisor and regulator. Nobody, however, objects to this.

13.44 There is some precedent for a distinction being made between the Official Receiver as liquidator and private sector liquidators under the Insolvency Act. In the United Kingdom, where the Official Receiver is liquidator, there is no committee of inspection whatsoever, but there may be a committee where a private sector liquidator is appointed.[159] Where the Official Receiver is liquidator, the functions of the committee are carried out by the Secretary of State, but where there is a private sector liquidator with no committee, the powers of the Secretary of State may be exercised by the Official Receiver.

13.45 The purpose of the recommendation is to provide appropriate checks and balances for liquidators, while at the same time saving both time and costs.

159 Insolvency Act, section 141(4) and (5) and the Insolvency Rules, rule 4.172.

Chapter 14 - General Powers of Court in case of Winding-up by Court

Section 209 Power to stay winding-up

14.1 The section provides that the court may at any time after an order for winding-up, on the application of the liquidator, the Official Receiver, or any creditor or contributory, on proof that all proceedings in relation to the winding-up ought to be stayed, make an order staying the proceedings, either altogether or for a limited time, on such terms or conditions as the court thinks fit.

14.2 A stay is usually only granted in circumstances where the applicant can satisfy the court that a stay would act for the benefit of all the parties concerned in the winding-up, such as where a scheme of arrangement has been accepted by all the parties. If a stay is granted on that basis, a liquidation should come to an end and there should be no reason for the winding-up to be stayed for a limited period only.

14.3 The *Consultation Paper* stated that was unlikely, and probably undesirable, that the court should only stay a winding-up for a limited time, and it proposed that the words "*either altogether or for a limited time*" should be replaced by the word "*altogether*" with the intention that the court could only stay a winding-up permanently.

14.4 We accept that this proposal was wrong. Three submissions pointed this out. One submission stated that it was desirable for the court to have the power to stay a winding-up for a limited time, for example, where directors might have ignored a statutory demand and the company might have been quite capable of paying its debts as and when they fell due. In that case, the court would need to be satisfied that the petitioning creditor had been paid and that the company was generally solvent. To do so, the court might want to stay the liquidation for a period of, say, one or two weeks. The proposal is therefore amended and we **recommend** that the provision should remain as it is.

Court to review, rescind or vary any order

14.5 A submission pointed out that the Insolvency Rules made provision for the court to review, rescind or vary any order made by it in the exercise of its jurisdiction. The Insolvency Rules also provided that any application for rescission of a winding-up order had to be made within seven days after the date on which the order was made.[160]

14.6 A similar provision exists under the Bankruptcy Ordinance.[161] We **recommend** the adoption of this provision as the consequence of a permanent stay is that, technically, the company remains subject to the order, even though its operation is suspended.

[160] The Insolvency Rules, rule 7.47(1) and (4).

[161] The Bankruptcy Ordinance, section 98.

14.7 The Official Receiver's Office submitted that, where winding-up proceedings were stayed altogether, the liquidator should be released immediately without any further court order. The Official Receiver's Office also submitted that there should be specific provisions for the costs of applications by the Official Receiver for stays to be paid and that rules should set out procedural requirements in detail. We agree with the submission and **recommend** the adoption of such provisions.

Section 209A Power of court to order winding-up to be conducted as creditors' voluntary winding-up
Section 209B Consequences of an order under section 209A
Section 209C Transitional

14.8 Section 209A provides that the court may, on the application of the liquidator or a creditor, within three months[162] after the date of a resolution of creditors to make an application[163], order that a winding-up of a company by the court shall be conducted as if the winding-up was a creditors' (insolvent) voluntary winding-up. The section also makes provision for matters that the court should have regard to, under sub-section (2).

14.9 Section 209A is Hong Kong's own: no other jurisdiction, to the best of our knowledge, has adopted a similar provision. The Official Receiver's Office would like to have it, together with sections 209B and 209C, abolished. Creditors of certain companies which are being wound-up by the court certainly want it retained.

14.10 The section appears to have originated in a recommendation in England in 1962,[164] made in what is known as the *Jenkin's Report*, but when the next amendments to the United Kingdom Companies Act were made in 1967 the provision was not included. The Standing Committee on Company Law Reform in Hong Kong had looked at the *Jenkin's Report* among other reports and provisions but there were delays in putting together a Companies (Amendment) Bill until 1984 by which time the recommendations of the *Cork Report*, which was published in 1982, were not considered. As a consequence, section 209A suddenly appeared in legislation, it appears, by default.

14.11 The history of the provision was set out by the court in a recent case.[165] The court commented that at the time of its original introduction it did:

> *"... not seem to have occurred to those responsible that the recommendation which they were implementing needed to be fleshed out if it were to work.... This resulted in a comprehensive code*

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162 This period may be extended by the court.

163 Provision is also made for companies wound-up in a summary manner under section 227F but as such companies have few assets, liquidators and creditors of such companies are unlikely to use this provision.

164 *Report of the Company Law Committee.* The Committee was appointed by the Board of Trade on 10 December 1959 (Cmnd. 1749).

165 *Re Conso Electronics (Far East) Ltd. (In liquidation)* [1995] 2 HKC 327, at 329.

regulating the powers of the court to make such an order and providing for its consequences to be found in new sections 209A and 209B, introduced into the Ordinance[166] *in 1990."*

14.12 The main reason that companies use the conversion provision under these sections and the main reason for the opposition to the provision of the Official Receiver's Office relates, we believe, to money. Nobody denies that the major reason that applications under section 209A have happened is because, by converting to a creditors' (insolvent) voluntary winding-up, the company can avoid payment to the Official Receiver of the scale fees set out in paragraph I of Table B of the Companies (Fees and Percentages) Order. Section 7 of the Order provides that the percentages shall be paid by a private sector liquidator on submission of his accounts to the Official Receiver under section 203, or, where the Official Receiver is liquidator, before he is released under section 205. There are other legitimate reasons for converting, however, as there is less court supervision, fewer procedures and generally less expensive in a creditors' (insolvent) voluntary winding-up than in a winding-up by the court.

14.13 We are not aware how much the Official Receiver's Office has lost out on in fees by use of the section but the Official Receiver's Office has advised that there have been 19 applications under the section, of which 11 occurred after the amendments in 1990.[167]

14.14 The fees can add up under the Companies (Fees and Percentages) Order. On the first $500,000, the fee is 10 per cent; on the second $500,000, the fee is 7.5 per cent; on the next $4 million the fee is 6.5 per cent; on the next $5 million the fee is 3.75 per cent; on the next $40 million the fee is 2 per cent, and on all further amounts the fee is 1 per cent. The fee on an aggregate amount of assets realised and brought to credit in a $100 million estate would amount to $1,835,000. In an estate of $10 million the fee would be $535,000 or 5.35 per cent of the total amount.

14.15 The Official Receiver's Office does not lose out entirely on fees in the case of companies which use section 209A as it would still have charged other fees as they arose under the Companies (Fees and Percentages) Order. Once a conversion order is made, however, if the assets remain undistributed for more than six months, the liquidator must pay them into the Companies Liquidation Account under section 285 of the Companies Ordinance and interest of such amounts would then become subject to the Official Receiver' s fee of 1.5 per cent under section 295.

14.16 If companies can convert to a creditors' (insolvent) voluntary winding-up, it takes the fees away from the Official Receiver and makes them available for the creditors. We would point out that although the majority of members of the Insolvency Sub-committee favour the retention of the provision, this should not be construed as a comment that the Official Receiver's Office is trying to profit unreasonably from creditors' (insolvent) voluntary windings-up. The issue is one of balancing the interests of creditors on the one side against the need for the Official Receiver's Office to be adequately funded on the other.[168]

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166 Companies (Amendment) (No. 4) Ordinance (No. 59 of 1990).

167 The Companies Registry reported that between February 1990 and December 1998 there were 15 conversions under section 209A. These include conversions in the liquidations of *Carrian Holdings Ltd.* and *Carrian Investments Ltd.* in 1990, *Conso Electronics (Far East) Ltd.* in 1993 and *L & D Associates Ltd.* in 1997.

168 See the recommendations on the funding of the Official Receiver' s Office, at Chapter 5.

Minority view

14.17 The comments made on the section represent the majority view of the Insolvency Sub-committee. A minority view has been expressed that the section, and section 209B, should be abolished on the ground that the provision did not appear in any other jurisdiction and that its sole purpose was to avoid the payment of the ad valorum fee under the Companies (Fees and Percentages) Order and that the effect of the provision was to allow the participants in a liquidation the opportunity to second guess the situation at an appropriate time in order to avoid the legitimate fees of the Official Receiver. The effect of the section is to unbalance the administrative side of the winding-up provisions.

14.18 In addition, conversion would take the control of the liquidation out of the hands of the court, but only after the creditors found that the court was the only recourse where directors had refused to go into a creditors' (insolvent) voluntary winding-up, and that it was too complex a provision to have to explain to creditors at the first meeting of creditors.

Majority view

14.19 We concur with the majority of the Insolvency Sub-committee. We accept the minority view insofar as it goes but we consider that the minority view addresses the question of the funding of the Official Receiver's Office, which is a matter of major importance in respect of the overall recommendations, rather than whether the provision should be retained on its own merits.

14.20 On its merits, it is logical that since it is possible under the Ordinance to convert a creditors' (insolvent) voluntary winding-up into a winding-up by the court[169] there should be a corresponding provision to allow conversion from winding-up by the court to a creditors' (insolvent) voluntary winding-up. In the case of section 209A, creditors are simply reacting to a form of market situation and, as things stand, if a conversion saves a company costs, it would be prudent to take the opportunity. It is the way that the fees are extracted that is at fault, not the provision.

14.21 Comment was unexpectedly muted on this section with one submission in favour of retention and one against. Most importantly, we note that in recent applications to the court for conversion, the court has considered whether there was a public interest element in keeping liquidations within the ambit of the court.[170]

Application of sections 182, 183 and 186 to voluntary windings-up converted from windings-up by the court

14.22 A submission by the Bar Association to the Standing Committee on Company Law Reform has been brought to our attention. The submission raised questions about the application of sections 182, 183 and 186 in cases of voluntary windings-up converted from a winding-up by the court and commented:

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169 Under section 257 of the Companies Ordinance.

170 See the decision of Le Pichon J. in the matter of Peregrine Fixed Income Ltd. (in liquidation), [1998] 4 HKC, Part 2, 151 [CFI].

"The purpose of a voluntary winding-up, whether members' or creditors', is to divorce its control from the court, including the right to bring proceedings against the company in liquidation. Thus it is difficult to see any basis for the application of sections 182, 183 and 186 in the case of voluntary winding-up converted from a compulsory winding-up when an ordinary members' or creditors' voluntary winding-up is not governed by any of these provisions. Moreover, section 182 does not apply once a company has been ordered to be wound-up as all the directors become functus. No liquidator has ever applied to the court for the disposal of an asset under that provision as its powers and duties are governed by the Ordinance. In the circumstances, it is all the more puzzling why section 182 remains applicable to a converted creditors' voluntary winding-up."

14.23 The *Conso Electronics* case considered whether the effect of the provisions of section 209A and 209B were that matters of substance continued to be regulated "*as if*"[171] the company was in compulsory winding-up and that matters of procedure were regulated "*as if*" the company was now in a creditors' (insolvent) voluntary winding-up. The court concluded that, by the section 209A order, the compulsory winding-up was for all purposes converted into a creditors' (insolvent) voluntary winding-up.[172]

14.24 The Official Receiver advised and we **recommend** that it will be necessary to re-draft the provision to make it clear that these sections would only apply in cases where the sections had been utilised while the company was in compulsory winding-up. In that case, decisions made in respect of these sections would still apply after conversion, but if the sections had not been applied while the company was in compulsory winding-up, they could not be applied after the liquidation was converted to a creditors' (insolvent) voluntary winding-up.

Section 210 Settlement of list of contributories and application of assets[173]

14.25 The section provides that a liquidator in a winding-up by the court,[174] as an officer of the court, shall settle a list of contributories and shall cause the assets of the company to be collected and applied in discharge of its liabilities. The court may, however, dispense with the settlement of a list of contributories.

14.26 In practice, a list of contributories is only made where shares have been partly paid up. We understand from the Official Receiver's Office that it encounters this situation every so often. When it happens, however, it is a costly and time-consuming exercise. One submission disputed that it was costly and time consuming, stating that it was cumbersome in that contributories needed to be written

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171 See section 209A(1).

172 *Re Conso Electronics (Far East) Ltd. (In liquidation)* [1995] 2 HKC 327, at 333, see paragraph 14.11 above.

173 See also the Companies (Winding-up) Rules, rules 66 to 73. Note that a recent addition to the Companies Ordinance, section 264A, provides for the payment of interest to contributories in the event of the winding-up of a company which was not insolvent.

174 Section 210(1) provides that the court shall settle the list but the Companies (Winding-up) Rules, rule 66, passes the privilege on to the liquidator.

to several times but that the forms were straightforward and the information was readily available and certain in all but the rarest of cases.

Power to settle lists of contributories to be delegated to liquidator

14.27 The Insolvency Act, section 148, is the equivalent of this section and is identical in its terms. Section 160 of the Insolvency Act, which is similar in terms to section 226 of the Companies Ordinance, additionally provides for the delegation of certain of the court's powers to liquidators including the power to settle a list of contributories, to rectify the register of members where required, and the collection and application of the assets of the company, to be exercised and performed by the liquidator, subject to the court's control. The Insolvency Act, rule 4.195, delegates the power to settle a list of contributories to the liquidator. We **recommend** that power to settle a list of contributories under section 226 should be delegated to the liquidator under the Companies (Winding-up) Rules. We **recommend** that, in addition, the power to dispense with the list of contributories should also be delegated to liquidators.

Inclusion in list may result in unpaid capital being called

14.28 The Companies (Winding-up) Rules, rule 69, provides a procedure for settling the list of contributories. The Insolvency Act, rule 4.198(2)(c), the equivalent of rule 69, additionally provides that the notice given to each person on the list shall state that in relation to any shares or interest not fully paid up, his inclusion in the list may result in the unpaid capital being called. We **recommend** that this provision should be added to rule 69.

Objection to entry in or omission from list

14.29 The Insolvency Act, rule 4.198(3), provides that the notice shall inform any person on the list that if he objects to an entry in, or omission from, the list, he should inform the liquidator in writing within 21 days from the date of the notice. The Insolvency Act, rule 4.198(4), then provides that the liquidator has 14 days in which to advise the person that he has either amended the list or that the objection is rejected. We **recommend** that the Insolvency Rule provisions be adopted.

14.30 The Companies (Winding-up) Rules, rule 70, provides that on the date appointed for the settlement of the list, the liquidator shall hear any objections and rule 72 allows anyone who objects to the settled list to apply to the court for the list to be varied.

14.31 These rules would need to be changed if the recommendations for the adoption of the Insolvency Act, rules 4.198(3) and (4), are adopted. The Insolvency Act, rule 4.199, provides that if a person still objects to the liquidator's decision under rule 4.198(4), he may apply to the court for an order removing the entry to which he objects or for otherwise amending the list. We **recommend** that the Insolvency Act, rule 4.199, be adopted.

Section 211 Delivery of property to liquidator

14.32 The court may require any contributory, trustee, receiver, banker, agent, or officer of the company to pay, deliver, convey, surrender, or transfer, within a time ordered by the court, to the liquidator any money, property, or books and papers which he has to which the company is *prima facie* entitled. The Companies (Winding-up) Rules provide that the power shall be exercised by the liquidator.[175]

14.33 The provision is a list which, though wide, would have the effect of limiting its application to the parties described. The provision does not, for example, apply to employees. Additionally, the provision is limited to winding-up by the court.

Provision to extend to voluntary winding-up

14.34 We **recommend** that the provision should be extended to cases of voluntary winding-up and that it should be extended to include any other party. This would expand those subject to the provision beyond those persons who either derive their authority from the company or are accountable to it.[176]

14.35 We received a submission that the provision should not apply to a members' (solvent) voluntary winding-up. The submission, however, did not give any reasons as to why it should not apply. In any event, we note that the section can be applied to voluntary windings-up by virtue of section 255. The recommendation, therefore, is only one that would make the current situation obvious.

Any person may be required to hand over assets

14.36 We **recommend** the adoption of the equivalent section under the Insolvency Act, section 234, which provides that "*any person*" who possesses or controls assets of the company may be required by the court to hand over the assets.[177] The provision is not limited to winding-up by the court and applies to any liquidator and so to any form of liquidation. It also applies where a provisional liquidator has been appointed.

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175 Companies (Winding-up) Rules, rule 67.

176 See *Re Crownhall Investments Ltd. (In Liquidation) & anor* [1992] 1 HKC 137 C.A.

177 See the recommendation that the court should have the power to order persons examined to deliver property to the liquidator , at paragraph 14.75.

Delivery of property to be extended to provisional supervisors

14.37 We **recommend** that the provision should apply to provisional supervisors in the event that the Commission's recommendations on the introduction of provisional supervision are brought into effect.[178]

Information held by auditors

14.38 We received a submission that the section should be expanded to include information as to the whereabouts of property and that, in particular, it should be extended further to include accounting information held by the auditors. The submission considered it daft (sic) that when a liquidator did not have access to books and records, for instance, because the directors had fled and taken them with them, the liquidator could not ask the auditors for copies of the schedules contained in their working papers specifying, in more detail than the audited accounts, the assets of the company.

14.39 We suggest that it might be possible for a liquidator to gain access to accounting information held by auditors by examination under section 221(1). We are not sure whether a company in liquidation would be *prima facie* entitled to information and papers presumably created by an auditor and which would not normally come into the possession of the company.

Section 212 Payment of debts due by contributory to company and extent to which set-off allowed
Section 213 Power of court to make calls
Section 214 Payment into bank of moneys due to company
Section 215 Order on contributory conclusive evidence

14.40 The corresponding provisions under the Insolvency Act are similar to the current provisions.[179] Under the Companies (Winding-up) Rules, rule 75, the application by the liquidator for leave to make a call has to be by summons to the contributories whereas under the Insolvency Act, rule 4.204, the application is *ex-parte*. We **recommend** that the rule under the Insolvency Act be adopted.

Section 216 Appointment of special manager

14.41 The section provides that where the Official Receiver is liquidator or provisional liquidator he may, if satisfied that the nature of the company's business or the interests of the creditors and contributories requires the appointment of a special manager, apply to the court for the appointment of a special manager to act as the court may direct.

178 See the *Report on Corporate Rescue and Insolvent Trading*.

179 See generally Insolvency Act, sections 149 to 152, and the Insolvency Rules, rules 4.195 to 4.202.

14.42 The court must therefore consider two points which do not necessarily complement each other, the nature of the company's business and the interests of the creditors. The problem for the court lies with marginal companies which have some assets to be managed but whose assets would be eroded by the special manager's charges. It would not be in the interests of the company or the creditors to let the business disappear from neglect but, equally, it would be disadvantageous to the creditors for the assets to be spent on the special manager's fees.

14.43 The *Consultation Paper* proposed refining the provision so that the court would only be required to consider whether the nature of the estate or the business of the company required the appointment of a special manager and it also proposed some changes in the wording of the section.

14.44 A submission stated that a balance of conflicting issues needed to be struck for each case and that that was a function of the court. We accept this point and retreat from the proposals. The two matters for consideration by the court should be retained. We **recommend** that a further test should be added to provide the court with a discretion to appoint a special manager in other appropriate cases. One submission described the special manager as a "*useful beast*" and we see no reason to limit the circumstances under which he might be utilised.

Section 217 Exclusion of creditors not proving in time

14.45 In a winding-up by the court, the court may fix a date on or before which creditors are to prove their debts or claims. Any creditor who has not proved before the date fixed shall be excluded from the benefit of the next distribution made after that date and from any previous distribution. The provision is supported by a number of rules.[180]

14.46 The Hong Kong Society of Accountants made a submission to the Insolvency Sub-committee prior to the publication of the *Consultation Paper* as follows:

> "*With regard to the notice to creditors to prove their debts, we consider that compared to section 217* (which relates only to winding-up by the court)*, winding-up rule 93* (which relates to any winding-up) *might not be as 'watertight' as far as the discharge of the liquidator's duties dealing with 'late' claims is concerned. It is noted that the wording in rule 93 is slightly different from section 217; further, section 217 carries the authority of a court order in a compulsory liquidation whereas rule 93 is relatively unclear in voluntary liquidations as to whether a creditor not proving in time may eventually succeed in challenging the liquidator's decision to exclude the creditor from the next and all previous dividends. It is noted that a liquidator in a compulsory liquidation is afforded the further 'protection' of winding-up rule 142(2).*

[180] See generally the Companies (Winding-up) Rules, rules 79 to 105 and rules 142 and 143.

A typical situation is whether a liquidator in a members' voluntary liquidation can rely solely on the ' protection' of rule 93 to advertise a notice to submit claims immediately upon appointment and then, on the basis of no claims having been received within 14 days, proceed to distribute all surplus assets to the contributories and then immediately close the liquidation.

We suggest that procedures for fixing a final deadline for lodging claims in any liquidation be reviewed, balancing the interest of maximum early distributions in a liquidation with that of long tailed claims (claims that are likely to take a long time to be quantified)*, for example, in a liquidation involving an insurance company."*

14.47 The court order referred to in the submission does not have to be used by a liquidator in a winding-up by the court on every occasion. The section states that the court " *may*" exercise its power to fix a date on or before which creditors are to prove their debts. The Companies (Winding-up) Rules, rule 93, provides that liquidators in a winding-up by the court, or in any other form of winding-up, should give notice to creditors to prove their debts.

14.48 The Hong Kong Society of Accountants suggested that the procedures should balance the interests of providing early distributions against considerations relating to claims that were likely to take a long time to be quantified. In practical terms, we do not see how the legislation can provide comprehensively for the variety of situations that arise in relation to claims. A recent amendment to the Bankruptcy Ordinance on the valuation of unliquidated claims should be of assistance to liquidators in this regard as it would provide a quantification of a claim in shorter time than could otherwise be achieved.[181]

14.49 A liquidator can never totally rely on rule 93 to the extent that he can advertise a notice to submit claims and, after distribution of all assets, close the liquidation. In practice, a liquidator needs to have a tax clearance certificate before he can complete a liquidation and no prudent liquidator would pay claims 14 days after giving notice under rule 93. He would have to hold over a reserve of money in the event of late claims and for any possible tax exposure.[182]

14.50 We understand that, typically, liquidators write to creditors several times in relation to claims in addition to providing notice under rule 93. We also understand that the court, in any event, is likely to order that the date fixed should be advertised widely.

14.51 The *Consultation Paper* accepted that the situation was not ideal as it meant that there was uncertainty surrounding the completion of a liquidation and suggestions were requested as to how the situation could be improved.

14.52 Submissions on the section were not passionate for change but two submissions suggested the adoption of the provisions under the Insolvency Act, section 153, and Insolvency Rules, rules 4.182 and 4.182A. Section 153 differs from this section only in that it provides that creditors would be excluded from any previous

181 See the amendment to section 34 of the Bankruptcy Ordinance under the Bankruptcy (Amendment) Ordinance 1996 (No. 76 of 1996), section 25. Section 34 of the Bankruptcy Ordinance is applied to the Companies Ordinance by section 264 of the Companies Ordinance.

182 See the comments in this regard on section 239 at paragraphs 23.20 to 23.30.

distributions and not from the next distribution. The Insolvency Rules do not appear to add anything helpful to the current provisions. The submissions stated that the rules gave protection to creditors by requiring a liquidator to make provision for certain late or disputed claims and they gave protection to liquidators by excluding creditors from earlier distributions. In a members' (solvent) voluntary winding-up, the rules allow the liquidator the comfort of knowing that he can distribute to shareholders without the risk of a late proving creditor disturbing that distribution or suing him personally, assuming that he has given notice in accordance with the rule.

Section 219 Inspection of books by creditors and contributories

Provision to apply to all forms of winding-up

14.53 On the making of a winding-up order, the court may make an order for the inspection of the books and papers of the company by creditors and contributories. We received a submission that this section was an example of a section which could be considered for common application to all modes of winding-up. We can see no reason why the provision should not apply to all forms of winding-up and **recommend** its adoption.

Access to information by creditors and contributories

14.54 A submission was also made to the effect that in a winding-up by the court, creditors and shareholders might apply to the court to inspect the books and papers of the company, or inspect the file of the company in liquidation kept by the court upon the payment of a small fee, under the Companies (Winding-up) Rules, rule 16, but that in practice, most creditors were not prepared to spend the money and effort to apply to the court or go to the Registrar and normally sought information from the liquidator. Since creditors have more of a beneficial interest than others when a company is in liquidation, the submission considered they should have relatively easy access to information as to the general progress of the liquidation, without imposing too much cost on the administration of the estate. The submission suggested that for both winding-up by the court and voluntary winding-up, a new requirement should be imposed on the liquidator to provide a copy of the resolutions passed at creditors' meetings to any creditor who so requested, upon the payment of a reasonable fee to the company in liquidation.

14.55 This submission was supported by another submission that some modest expenditure to keep creditors informed of the progress of the liquidation would also increase transparency, and would be well spent. We consider that we have addressed the need to keep creditors informed as to the progress of liquidations in the recommendation that any person should have the right to inspect the statement of a liquidator.[183]

14.56 While we are attracted to the idea of opening access to the books and papers of a company to creditors, we are concerned that this would leave a company in liquidation in danger from creditors involved in proceedings against the company in the course of the liquidation, using the provision to fish for evidence to support their

[183] See section 284 at paragraphs 23.39.

claim. While it is acknowledged that the process of discovery of evidence can result in cases being settled or discontinued before going to court, discovery would equally apply to a company in liquidation.

14.57 A solvent company involved in proceedings with another party would refuse to open its records to inspection by that party and we see no reason for making provision for this in the case of a company in liquidation without the party first having obtained an order of the court. We consider that the section should be left as it is.

Section 221 Power to summon persons suspected of having property of company[184]

14.58 After the appointment of a provisional liquidator, the court may summon before it, for what is known as private examination, any officer of the company or person known or suspected to have property of the company, or supposed to be indebted to the company, or any person whom the court believes capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.

14.59 We considered public and private examinations under the Bankruptcy Ordinance and the *Report on Bankruptcy* reflected these views.[185] It is our intention that the winding-up provisions on public and private examination should mirror the Bankruptcy provisions insofar as possible. Many of the recommendations on examination in the *Report on Bankruptcy* are now contained in the Bankruptcy Ordinance as a consequence of the Bankruptcy (Amendment) Ordinance 1996. These recommendations were often based on provisions contained in the bankruptcy provisions of the Insolvency Act.

Receivers should not be able to apply under the provision

14.60 The Insolvency Act, section 236, is the equivalent of section 221. Section 236 applies the Insolvency Act, section 234,[186] in terms of which insolvency office-holders may apply under the provision. The Insolvency Act includes administrative receivers, which, though there is no equivalent office under the Hong Kong provisions, is a close relation to receivers under the Hong Kong system. We would not support the idea of section 221 being available to receivers.

Self-incrimination

14.61 The concept of obliging a person to give evidence against himself that could be used in evidence against him in a criminal case has implications in terms of the rights of the individual that go beyond insolvency law. This applies as much

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184 In this and the next section we make wide reference to recommendations made in the *Report on Bankruptcy* on the corresponding sections in the Bankruptcy Ordinance, sections 29 and 19 respectively. For convenience we have substituted the term "*liquidator*" for the term "*trustee in bankruptcy*".

185 See Chapters 11 and 12 of the *Report on Bankruptcy*. For recommendations under this section, see generally Chapter 12 of the *Report on Bankruptcy*.

186 The Companies Ordinance equivalent of which is section 211.

elsewhere as in Hong Kong and the quotation below on the corresponding Insolvency Act provisions applies just as much to the Companies Ordinance:

> *"There has been a vigorous exploration of the provisions of section 236 in a series of cases, some of which have been appealed all the way to the House of Lords.... the courts, in their approach to section 236, have been conscious of the need to balance a variety of different principles and divergent interests, including the consensus of society at large to pursue effective investigations in the face of determined and sophisticated resistance on the part of those whose conduct is under scrutiny. On the other hand, it cannot be denied that the extensive powers conferred by section 236, if applied without some degree of sensitivity, have the capability at times of posing an impossible dilemma for persons under investigation, and thereby put in question the prospect of a 'fair' trial on matters which may be technically distinct from, although practically related to, the actual insolvency process itself.*
>
> *In Joint Administrators of Cloverbay Ltd. v. Bank of Credit and Commerce International S.A.,[187] the Court of Appeal formulated guidelines for the exercise of the court's discretion to order examinations of persons under section 236(2). These guidelines were re-examined very soon afterwards, and further elaborated, by the Court of Appeal and House of Lords respectively in Re British and Commonwealth Holdings plc (No. 2),[188] on the basis of a full review of the case law relating to the current section and its statutory predecessors. Ralph Gibson L.J., whose judgment was later endorsed by the House of Lords, affirmed that seven principles were clearly established by authority:*
>
> *(1) the discretion conferred on the court by section 236(2) is an unfettered and general one;*
> *(2) that discretion nevertheless involves balancing the requirements of the office-holder against possible oppression to the person from whom information is sought;*
> *(3) the power conferred by the section is an extraordinary one whose existence is due to the fact that the office-holder usually comes as a stranger to the relevant events;*
> *(4) the power can be used not merely to obtain general information but to discover facts and documents related to contemplated claims, whether proceedings have been started or not, against the proposed witness or someone connected with him;*
> *(5) the power is directed to enabling the court to help the office-holder to complete his function as effectively and with as much expedition as possible, and to discover*

187 [1991] Ch. 90 C.A.

188 Decided by a majority of the Court of Appeal [1993] A.C. 426 and unanimously by the House of Lords [1992] Ch. 342.

with as little expense and as much ease as possible, the facts surrounding any possible claim;

(6) great weight is to be given to the views of the office-holder, who will have detailed knowledge of what problems exist and what information he needs;

(7) matters relevant to the balancing exercise will include that:

(a) the case against a former officer will usually be stronger, since he owes both a fiduciary duty to the company and a duty under section 235 of the Act to assist the office-holder;

(b) to ask a third party to expose himself, by giving information, to liability involves an element of oppression;

(c) an order for oral examination is more likely to be oppressive than one to produce documents;

(d) to require a person suspected of wrongdoing to prove the case against himself on oath to proceedings being brought, is oppressive." [189]

14.62 A respondent[190] should be obliged to answer all questions that are put to him in his examination but his answers may not be used as evidence against him in criminal proceedings, subject to perjury. This *Report on Bankruptcy* recommendation was adopted in the Bankruptcy Ordinance.[191] We **recommend** its adoption.

14.63 This is not the position under the Insolvency Act. Case law has established that an officer of an insolvent company who is summoned under Insolvency Act, section 236, cannot refuse to answer questions on the ground that to do so might tend to incriminate him.[192] The *Report on Bankruptcy* considered the matter fully and, commenting that the main objective of the examination provisions is to recover assets and make distributions to creditors, made the above recommendation. The *Report* took into account article 11(2)(g) of the Hong Kong Bill of Rights which provided that:

> " *(2) In the determining of any criminal charge against him, everyone shall be entitled to the following minimum guarantees, in full equality-*
>
> *…(g) not to be compelled to testify against himself or to confess guilt.*"

14.64 We received a submission that there should be a distinction between directors and officers of the company, who owed duties to the company, and unconnected third parties who did not owe such duties and that given that the primary purpose of an examination was to facilitate "*the recovery of assets and the ascertainment of the validity of creditors' claims*"[193], the interests of an unconnected party, including a creditor, should not be prejudiced in favour of the creditors. The submission stated that such a third party should not be required to answer questions relating to a claim or a possible claim against him or someone connected with him

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189 *The Law of Insolvency*, Ian F. Fletcher, 2nd edition, pages 562 and 563.

190 For convenience, we refer in this and the next section to "*respondent*". This term is intended to include any person who is examined under the sections, unless specifically described.

191 See the Bankruptcy Ordinance, section 29(3B).

192 *Bishopsgate Investment Management Ltd. v Maxwell* [1992] BCC 214.

193 *Report on Bankruptcy*, paragraph 12.2.

and that any required information should be obtained from the directors and officers of the company. Any information obtained from a third party should not be admissible in evidence against him in any civil or criminal proceedings.

14.65 We suggest that the submission is being unnecessarily fearful. Under the recommendation, the answers of a respondent in an examination under this section could not be used in criminal proceedings against him. A similar protection against the use of the section for "*fishing expeditions*" already exists in civil proceedings.

Examination to be extended to voluntary windings-up

14.66 The private examination of persons under this provision is limited to cases of winding-up by the court, though there may be an examination in a voluntary winding-up if the court is prepared to exercise its powers under section 255. The Insolvency Act equivalent, section 234, applies to any company which is insolvent or in liquidation. We **recommend** that the provision should be extended to cases of voluntary winding-up, though not to provisional supervision.

Application only by liquidator

14.67 The corresponding provision under the Bankruptcy Ordinance, section 29, provides that the application to the court must be made by the trustee or the Official Receiver. Similarly, under the Insolvency Act, the application must be made by the liquidator. Section 221 is silent as to who may make the application. We **recommend** that the application should only be made by the liquidator.

Application inter partes unless circumstances demand ex parte application

14.68 The provision is silent as to whether the application should be made *ex parte* but we understand that, until recently, it has been the practice for applications to be so made. We understand that recently the court has been reluctant to make an order without first hearing the person to be examined.

14.69 This issue was addressed in the *Report on Bankruptcy* which recommended that applications for private examinations should be *inter partes* except where the liquidator reported to the court that the application would cause the respondent or others to take actions that would be likely to cause injustice to the application or where the risk of uncompensatable loss was clearly outweighed by the risk of injustice to the applicant if the order was not made.[194] In cases where a liquidator would make an *ex parte* application, he should first make full disclosure of the facts of the case to the court, in whose discretion it should lie to make an order. We endorse this approach and **recommend** that it should be adopted.

Examination on matters considered relevant

[194] See the Bankruptcy Rules, rule 87B(2).

14.70 The *Report on Bankruptcy* recommended[195] that the court, in addition to examining a person on matters concerning the debtor, his dealings or property, should also be able to examine him on any other matter the court considered relevant. We **recommend** that this additional wording should be added at the end of section 221(1).

Legal representation of person to be examined

14.71 The *Report on Bankruptcy* recommended and we **recommend** that a person should be entitled to be legally represented at his examination provided it is at his own expense. The legal representative should be able to put to the respondent such questions as the court would allow for the purpose of enabling him to explain or qualify any answers given by him. The legal representative should also be able to make representations on his behalf.[196]

Inspection of liquidator' s report to the court

14.72 The *Report on Bankruptcy* recommended and we **recommend** that it should be in the discretion of the court to allow inspection of the liquidator' s report to the court.[197]

Costs may be paid by the person examined

14.73 The *Report on Bankruptcy* recommended and we **recommend** that the court should have the power to order that the costs of an examination should be paid by the respondent if it appears that the examination is made necessary because information requested by the liquidator has been unjustifiably withheld by the respondent.[198]

14.74 The *Report on Bankruptcy* recommended and we **recommend** that where a respondent has co-operated with the liquidator in his examination and in the production of documents the court should have the discretion to order that the legal costs of the respondent shall be borne by the estate.[199]

Court may order payment of money or delivery of property etc.

14.75 The *Report on Bankruptcy* recommended and we **recommend** that on examination, where it appears to the court that the person examined, the respondent, is indebted to the company or has in his possession property belonging to the company, the court may order the respondent to deliver such sum or property, or any part of the sum or property, as the court thinks fit, to the liquidator.[200] There is a similar provision under the Insolvency Act, section 327.

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195 See the Bankruptcy Ordinance, section 29(3).
196 See the Bankruptcy Rules, rule 87B(6) and the Insolvency Rules, rule 9.4(5).
197 See the Bankruptcy Rules, rule 87B(5).
198 Similar provision is made under the Insolvency Rules, rule 9.6.
199 See the Bankruptcy Rules, rule 87C.
200 See the Bankruptcy Ordinance, section 29(5).

Perjury

14.76 The *Report on Bankruptcy* recommended and we **recommend** that a warning should be placed in the summons under section 221 to the effect that on conviction for perjury a person is subject to imprisonment for seven years and a fine.[201]

Affidavit of dealings

14.77 The *Report on Bankruptcy* recommended and we **recommend** that the court should have the power to require a respondent to submit an affidavit of his dealings with a company and to produce any documents in his possession or under his control relating to the company, the company's dealings, affairs or property. In the event of a respondent appealing against an order to produce an affidavit, the respondent should not be obliged to continue with the preparation of the affidavit prior to the hearing of the appeal, unless the liquidator makes a separate application for an order obliging the respondent to continue with preparation of the affidavit, and the court so orders. [202]

Interrogatories

14.78 The *Report on Bankruptcy* recommended and we **recommend** that the court should have the power to require a respondent to answer interrogatories.[203]

Production of documents by the Commissioner of Inland Revenue

14.79 We **recommend** that the court, on the application of a liquidator, may order the Commissioner of Inland Revenue to produce to the court any returns or accounts submitted by the company to the Commissioner, any assessment or determination made in relation to the company by the Commissioner, or any correspondence between the company or its representatives and the Commissioner, either before or after the commencement of the winding-up.

14.80 This recommendation would follow a provision introduced in the Bankruptcy Ordinance under section 30D. The provision also allows the Commissioner to apply to the court for discharge or variation of the order. Once the document is produced to the court, the court may disclose all or part of the contents of the document to the trustee in bankruptcy but the trustee shall not disclose the contents of the document unless they are disclosed as part of a private examination. No creditor or member of a creditors' committee is entitled to see the contents of a document disclosed to a trustee under the provision.

14.81 This matter was discussed at length in the *Report on Bankruptcy*.[204] The Report took the view that the trustee in bankruptcy should be able to "*stand in the shoes*" of the bankrupt as regarded his tax records, the effect of which would be that a liquidator should be able to see such tax records as a company would have been able to see, which resulted in provision being made for a trustee to be able to have

201 Crimes Ordinance (Cap. 200), section 31.
202 See the Bankruptcy Ordinance, section 29(1A) and the Bankruptcy Rules, rule 87B(3).
203 See the Bankruptcy Ordinance, section 29(3).
204 For a fuller discussion, see paragraphs 12.43 to 12.46 of the *Report on Bankruptcy*.

access to information that was sent by a bankrupt to the Commissioner, to assessments that were sent by the Commissioner to a bankrupt, and to any other correspondence between the Commissioner and a bankrupt.

14.82 The Commissioner of Inland Revenue was concerned that the secrecy provisions of the Inland Revenue Ordinance should not be compromised as confidentiality was one of the cornerstones of the taxation system and the secrecy provisions were understood to encourage frankness by taxpayers.

14.83 The Bankruptcy Ordinance provision appears to satisfy the Commissioner' s requirements as to confidentiality and to satisfy the requirements of trustees. We consider that the application of corresponding provisions to the winding-up of companies would satisfy the same needs.

Section 222 Power to order public examination of promoters, directors, &c.[205]

Fraud

14.84 In a winding-up by the court, where the Official Receiver has reported to the court that, in his opinion, a fraud has been committed in relation to the promotion or formation of the company or by any officer of the company in relation to the company since its formation, or in the case of an insolvent company, a *prima facie* case exists against a person that would render him liable to disqualification under the provisions for disqualification of directors under Part IVA of the Ordinance, the court may order the public examination of the person as to the promotion or formation or the conduct of the business of the company or as to his conduct and dealings as an officer of the company.

14.85 The corresponding provisions under the Insolvency Act, sections 133 and 134, do not require the need for such beliefs on the part of the Official Receiver. The new Insolvency Act provisions are seen as being designed to produce a wider use of the public examination procedure.

14.86 The *Consultation Paper* did not address this issue but we have received a submission that the requirement regarding fraud should be removed from the provision. We **recommend** that the fraud element should be removed. We note that there is no requirement in the equivalent provisions in the Bankruptcy Ordinance in relation to the public examination of a bankrupt.[206] We are also of the view that, for the most part, the winding-up provisions of the Companies Ordinance relate to civil matters and that this has become even more forceful in recent times with the introduction of unfair preferences in place of fraudulent preferences under section 266B. Also, another recommendation under this section would provide that answers given in response to questions put to a respondent under this section could not be used in evidence against him. We consider that these are compelling reasons for removing the fraud restriction.

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205 Many of the recommendations made in respect of private examination under section 221 also apply to public examination under this section. Note that references under this section to recommendations in the *Report on Bankruptcy* refer to Chapter 11 of the *Report*.

206 The Bankruptcy Ordinance, section 19.

Self-incrimination

14.87 The *Report on Bankruptcy* recommended and we **recommend** that a respondent should be obliged to answer all questions that are put to him in his public examination but his answers may not be used as evidence against him in criminal proceedings other than in relation to perjury. The protection, therefore, should not apply where a respondent does not give truthful answers in his examination.[207]

Legal representation of person to be examined

14.88 The *Report on Bankruptcy* recommended and we **recommend** that a respondent may at his own expense employ a solicitor with or without counsel, who may put to him such questions as the court may allow for the purpose of enabling him to explain or qualify any answers given by him, and may make representations on his behalf.[208]

Creditors may request and require liquidator to hold an examination

14.89 The *Report on Bankruptcy* recommended and we **recommend** that public examination should only be held on the application of the liquidator, or the Official Receiver, on the requisition of one quarter in value of the creditors. The court should also have the discretionary power to make an order for examination at the request of creditors making up less than one quarter in value of creditors.[209]

Inspection of liquidator's report to the court

14.90 The *Report on Bankruptcy* recommended and we **recommend** that it should be in the discretion of the court whether to allow inspection of the liquidator's report to the court, or part of it, by the respondent but the report should remain confidential unless the respondent can show that it would be unfair to him not to allow inspection.[210]

List of topics

14.91 The *Report on Bankruptcy* recommended and we **recommend** that creditors should furnish the liquidator with a list of the topics they intend to put to a respondent at a public examination.[211]

Costs may be paid by the creditors

207 The Bankruptcy Ordinance, section 19(9) and (10). See generally Chapter 11 of the *Report on Bankruptcy*.
208 See section 13 of the Bankruptcy (Amendment) Ordinance 1996.
209 See the Bankruptcy Ordinance, section 19(2).
210 See the Bankruptcy Rules, rule 82A(2).
211 See the Bankruptcy Rules, rule 82A(3).

14.92 The *Report on Bankruptcy* recommended and we **recommend** that the court should have a discretion to order that the costs of a public examination should be borne by creditors who have obliged the Official Receiver to hold an examination if the court considers that it is frivolous to have held the examination.[212] We wish to clarify the recommendation to the effect that the court should have a discretion in this regard and that any costs borne by creditors should be one set of costs.

Costs may be paid by the person examined

14.93 We **recommend** that the costs may be paid by the respondent if it appears that the examination was made necessary because information requested by the liquidator had been unjustifiably withheld by the respondent.

14.94 We also **recommend** that where a respondent has co-operated with the liquidator in his examination and in the production of documents, the court should have the discretion to order that the legal costs of the respondent shall be borne by the estate. These recommendations mirror recommendations under section 221. These two recommendations were not made as proposals in the *Consultation Paper* due to an oversight.

Perjury

14.95 We **recommend** that a warning should be placed in the order directing a public examination[213] that on conviction for perjury a respondent would be subject to imprisonment for seven years and a fine.

Special manager

14.96 The Insolvency Act, section 133(4), provides that a special manager appointed by a liquidator may take part in a public examination. We **recommend** that a special manager, appointed either by a private sector liquidator or by the Official Receiver under the panel for contracting out non-summary windings-up, should be able to take part in an examination.

Section 224 Power to arrest absconding contributory or officer

14.97 The Official Receiver's Office submitted that:

> *"The Report [Consultation Paper] contains no record of discussion nor sets out any comments on this provision.*
>
> *'Absconding' for the purpose for avoiding payment of liabilities due to the company or of avoiding examination respecting the affairs of the company is the main ground for application of issue of a warrant of*

[212] See the Bankruptcy Ordinance, section 19(8).

[213] Companies (Winding-up) Rules, form 29.

arrest.

The Official Receiver's Office has experienced difficulty in proving the target officer has ‘ absconded’ , which Mr. Justice Rogers as he then was, decided judicially that the word connotated “ leave hurriedly, secretly; hide and conceal” . The Official Receiver finds in a number of cases that officers simply disappear from their respective last known addresses and Official Receiver is not able to contact them. The Official Receiver proposes to amend the provision that the court may also make an order of arrest if there is probable cause for believing a contributory or any officer of the company deliberately conceals or absents himself from the usual or last known address with intent to avoid examination respecting the affairs of the company, to be in line with the provision of section 136 Bankruptcy Ordinance.”

14.98 We agree with the submission and **recommend** that the section should be amended to provide that the power to arrest contributories or officers should be exercised on the probable cause ground as expressed in the submission. We agree with the Official Receiver's Office that directors and others simply remove themselves from their last known addresses with the intention of avoiding their obligations. This recommendation was not proposed in the *Consultation Paper*.

Section 226 Delegation to liquidator of certain powers of court

14.99 We refer to the recommendation relating to this section under section 210. [214]

Section 226A Dissolution of company otherwise than by order of court[215]

14.100 The section provides that when the affairs of a company in a winding-up by the court have been completely wound-up and the liquidator has been released under section 205, the Official Receiver will certify to the Registrar of Companies that these conditions have been satisfied. Two years after registration of the certificate the company will be dissolved. The provision is subject to deferral of the date of dissolution on application to the court by the Official Receiver.

14.101 The Official Receiver pointed out that he was not in a position to certify that the affairs of a company which had been liquidated by a private sector liquidator had been completely wound-up and should not be required to do so.

214 See paragraph 14.27.

215 Sections 290 to 292A provide for dissolution in all forms of winding-up. Sections 239 and 248 apply to dissolution in members’ (solvent) voluntary winding-up and creditors’ (insolvent) voluntary winding-up respectively. Note the recommendations on dissolution in the case of solvent companies , under section 239.

14.102 We agree that the Official Receiver should not be obliged to certify matters over which he have no control or knowledge and **recommend** that liquidators should provide the Registrar of Companies with their own certificate. The Registrar of Companies has indicated that he agrees with this recommendation.

14.103 A submission pointed out that the reference to the liquidator's "*own certificate*" should not be taken to mean that the liquidator should devise his own form of confirmation. There should be a prescribed or standard form for this purpose. We **recommend** that there should be a standard form.

Section 227A Court may make a regulating order

14.104 The Official Receiver's Office submitted that Part V(iiA) needed to be reconsidered, pointing out that the procedure did not appear to exist in other jurisdictions. The submission noted that the major advantage was that it obviated the need to hold meetings in liquidations with large numbers of creditors or contributories.

14.105 Section 227A provides that the court may, by reason of the large number of creditors or contributories, or if for any other reason the interests of the creditors require it, order that the winding-up of a company shall be regulated by order of the court.

14.106 Where a regulation order is made, the court may dispense with the first meeting of creditors and appoint the Official Receiver or any other person as liquidator and appoint a committee of inspection.[216]

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216 Section 227B provides for the appointment of the liquidator and a committee of inspection.

14.107 The court may vary the procedure for ascertaining the wishes and directions of creditors.[217] There are also special provisions relating to compromises and schemes of arrangements under section 166.[218]

14.108 We are encouraged that the provision is only used on rare occasions as it has the effect of impinging on the rights of creditors to have a meeting of creditors, to appoint a liquidator and to elect a committee of inspection.[219] There has, however, been no submission calling for the abolition of the provision and we are satisfied that as the provision is only used when needed, and as the court must make an order, there is no need to make any amendments to the provision.

Section 227E Proof of debts

14.109 The section provides that in the case of the winding-up of a bank, any creditor who is a depositor shall be deemed to have proved his debt for both voting and dividend purposes. The purpose of the provision is to save labour as banks should already have records of the balances of depositors and all that is needed is a notice from the liquidator asking a creditor whether he agrees to the amount of the debt.

14.110 The section also provides that the relevant date shall have the meaning assigned to it by section 265(6), which provides that in a winding-up by the court the relevant date means the date of appointment of a provisional liquidator, or if no such appointment is made, the date of the winding-up order, unless in either case the company had commenced to be wound-up voluntarily before that date. In any case to which the above conditions do not apply, then the date of commencement of the winding-up applies.

14.111 The problem is that while the assets and liabilities of a bank in liquidation are determined at the beginning of the winding-up, their actual date of determination under the relevant date provision of section 227E is different.

14.112 The problem has been addressed in the following terms:

> *"Logically, the first question that arises in any discussion of Bank of Credit and Commerce (Hong Kong) LTD. (BCC(HK)) is, what is the insolvency date, i.e., the date at which the various procedures in the liquidation are to take effect. Normally of course this would be the date of the winding-up order except in relation to interest, which ceases to run on debts due from the insolvent as from the date of the commencement of the winding-up.*
>
> *In the BCC(HK) case the position is somewhat different. As already noted, BCC(HK) is subject to a regulating order. Accordingly, section 227E of the Companies Ordinance applies to provide a 'relevant date', namely the date of appointment of the provisional liquidator on 17th July 1991. This date is incorporated by reference from section 265(6). The relevant*

217 Section 227C provides for informing creditors and contributories and ascertaining their wishes and directions.

218 Section 227D provides for compromises and arrangements with creditors.

219 The Registrar of Companies has advised that in the three years prior to November 1998 eight regulating orders were made.

date applies for voting and dividend purposes. The section refers to ' net balances' and probably matters of set-off etc. are also to be determined with effect from that date. The section only applies, however, ' unless and until the Official Receiver or liquidator by notice in writing requires' the creditor ' to make a formal proof of debt' . The somewhat strange situation therefore arises that if the Official Receiver adopts the deeming provisions of Section 227E then the relevant date is 17th July 1991, but if he requires a proof to be filed, then for many purposes the insolvency date will in fact be 2nd March 1992.

This distinction can be of substantial significance where for example the creditor is claiming in a foreign currency and there have been large movements in the exchange rate between 17th July 1991 and 2nd March 1992 - for example Canadian Dollars, Deutsche marks or Japanese Yen. I should add that BCC(HK) itself appears to have a marked preference for using the date of 17th July 1991 for all purposes.

For completeness, it should not be forgotten that BCC(HK) was wound-up pursuant to the Banking Ordinance as well as the Companies Ordinance. Section 122(3) of the Banking Ordinance provides that for a number of purposes the winding-up shall be deemed to have commenced at the time the Commissioner of Banking took control of the Bank. Fortunately, these purposes do not, following a timely amendment to the Banking Ordinance in 1991, include Sections 264 or 265 of the Companies Ordinance." [220]

14.113 While there is probably no date that would completely satisfy all circumstances, it is unsatisfactory to have a situation where the relevant date can be altered, not to say manipulated. We are of the view that the relevant date should, insofar as possible, be the same in every instance. Section 184 provides commencement dates in winding-up by the court and in voluntary winding-up.

14.114 We **recommend** that section 184 should be the benchmark provision for the relevant date.[221] This would require the removal of the present sub-section (3) which provides that the relevant date shall have the meaning assigned to it by section 265(6). The relevant date for all issues in relation to winding-up by the court should be the date of commencement of the winding-up, that is, the date of the presentation of the petition for winding-up. In a voluntary winding-up, the relevant date should be the date of the resolution to wind-up the company.

14.115 This would also accord with the recommendations in the *Report on Corporate Rescue and Insolvent Trading* which recommended that 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.[222] It does not, however, accord with the date recommended in the *Report on Bankruptcy* that foreign currency debts should be converted into Hong Kong dollars at the date of the making of the bankruptcy order.

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220 "*BCC(HK) - a Perspective*" , *International Insolvency Review*, Autumn 1994, Volume 3, Issue 2, by Mark Bradley, Solicitor, Deacons Graham and James.

221 This accords with the position under the Insolvency Act, section 129 and the Singapore Companies Act, section 255.

222 *Report on Corporate Rescue and Insolvent Trading*, paragraph 16.35.

Section 227F Application of Ordinance to small winding-ups

14.116 The section provides that if the assets of a company are not likely to exceed $200,000, the court may order that the company should be wound-up in a summary manner. The effect is that the Official Receiver is appointed liquidator; there is no meeting of creditors and consequently no committee of inspection; and the Official Receiver does all things which may be done by a liquidator with the sanction of the committee of inspection. The court may, at any time before dissolution of the company, rescind the order.

14.117 The Official Receiver's Office reported that the vast majority of insolvency cases were unremunerative and fell into the category of "*summary cases*".[223] The contracting out scheme for non-summary cases, that is, those cases with assets of $200,000 or more has been expanded to the contracting out of summary cases, in what is known as the Panel B scheme. The effect of this is that, while the Official Receiver's Office remains the liquidator in a large number of summary cases, other liquidators are increasingly taking up summary cases.

14.118 In cases where the creditors' meeting appoints the Official Receiver as liquidator, the Official Receiver advises the meeting that his role is to monitor and regulate the performance of liquidators or special managers in non-summary cases and that he will apply to the court to appoint a special manager from the panel.

14.119 The Official Receiver's Office made a submission that the reference to "*Official Receiver*" in sub-sections (1)(b) and (1)(b)(i) should be amended to "*provisional liquidator*" and the like references in sub-sections (1)(b)(ii) and (2) should be amended to "*liquidator*". We **recommend** these amendments. The amendment is made necessary due to the Panel B scheme.

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223 In 1994, 81 per cent of winding-up cases were administered under the summary procedure. In 1995, the figure was 77 per cent and in 1996, the figure was 93 per cent. Note also the figures quoted by the Secretary for Financial Services at paragraph 5.10.

Chapter 15 - Resolutions for and Commencement of Voluntary Winding-up

Section 228 Circumstances in which company may be wound-up voluntarily

15.1 The section sets out the four circumstances by which a company may be wound-up voluntarily. They are:

- when the period, if any, fixed for the duration of the company by its articles expires or the event, if any, occurs on the occurrence of which the memorandum or articles provide that the company is to be dissolved, and the company in general meeting had passed a resolution requiring the company to be wound-up voluntarily; or

- if the company resolves by special resolution that the company be wound-up voluntarily; or

- if the company resolves by special resolution that it cannot by reason of its liabilities continue in business, and that it is desirable to wind-up; or

- if the directors of the company or, in the case of a company having more than two directors, the majority of directors, make and deliver to the Registrar a statutory declaration under section 228A(1).

15.2 The Hong Kong Society of Accountants pointed out that the final condition, under section 228(1)(d), which referred to all or a majority of the directors making a statutory declaration under section 228A(1), should be amended because section 228A(1), which was amended in 1993,[224] actually referred to the statutory declaration being made by only one of the directors. We **recommend** that section 228(1)(d) should be amended in the manner of section 228A(1) whether or not section 228A is abolished.

15.3 We have one concern with swearing by and written statements of directors under section 228A(1). Section 228A(2) provides that a director making a declaration under section 228A(1) shall be liable to a fine or imprisonment if he had no reasonable grounds for the opinion expressed in the statutory declaration.[225] We do not see why the director making the declaration should be the only one to be subject to this penalty as the statutory declaration only verifies the written statements of the other directors. We **recommend** that all directors who make written statements without having reasonable grounds for making the statements should also be liable to

[224] Ordinance No. 75 of 1993, section 14.

[225] The fine is $50,000.

the penalty. This recommendation should also apply to other winding-up provisions where one director verifies the written statements.[226]

15.4 These recommendations received some support and no opposition. We did receive a submission to the effect that in the case of an insolvency as envisaged in section 228(1)(c), a resolution by a simple majority, as opposed to a special resolution, should suffice. We do not agree with the submission on the ground that a simple resolution would allow a member or members of the company holding a slim majority of shares to resolve to wind-up the company. In the context of the family orientated nature of many Hong Kong companies it would be an undesirable step to take.

15.5 We note, in addition, that the notice requirements for meetings where special resolutions are to be presented are longer than those for ordinary resolutions.[227]

Section 228A Special procedure for voluntary winding-up in case of inability to continue business

15.6 The consultation process prior to the publication of the *Consultation Paper* attracted a number of submissions, none of them supportive of the provision and all of which advocated abolition or restrictions. The *Consultation Paper* proposed that the section, which was introduced under the Companies (Amendment) Ordinance 1984, should be abolished due, in part, to the weight of the submissions but also because other provisions in the Companies Ordinance were adequate for the purposes of winding-up a company efficiently and in a more appropriate manner. In addition, it is noted that the Registrar of Companies is also considering the introduction of a statutory procedure to deregister solvent and defunct private companies.[228]

15.7 The section empowers a majority of directors at a meeting, who have formed the opinion that the company cannot by reason of its liabilities continue in business, to resolve and deliver for filing to the Registrar of Companies a statutory declaration by one of the directors verifying written statements signed by the directors resolving that:

- the company cannot by reason of its liabilities continue in business; and

- they consider that it is necessary that the company be wound-up and that there are good and sufficient reasons for the winding-up to be commenced under this section; and

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226 See the recommendation under section 233, at paragraphs 16.3 to 16.9.

227 Note sections 114 and 116, particularly section 116(1)(a) which makes special provision for notice for a resolution to wind-up under section 228.

228 See the proposals of the Registrar of Companies, at paragraphs 17.25 to 17.32, and, on the recommendation that directors should be able to wind-up companies, see paragraphs 10.2 to 10.7.

- meetings of the company and of its creditors will be summoned not later than 28 days after the delivery of the declaration to the Registrar.

15.8 The fear expressed by the submissions prior to the publication of the *Consultation Paper* was that it gave unscrupulous directors the opportunity to wind-up a company in the period between the date of the resolution and the meetings of creditors and contributories, without reference to either the creditors or the shareholders and that unscrupulous directors could use the provision to their own advantage. The section allows directors, in effect, as agents of the shareholders, to take actions that should properly be taken by the shareholders.

15.9 The *Consultation Paper* noted that the provision had been described in the Insolvency Sub-committee as "*statutory Centrebinding*" [229] in reference to a case in the United Kingdom, which originated, though not in the actual case, a practice whereby unscrupulous liquidators nominated by equally unscrupulous directors could sell off assets of a company at a bargain price to purchasers close to the directors. The United Kingdom insolvency provisions now act to prevent the practice.[230] A 1993 amendment[231] to section 228A providing that any provisional liquidator appointed under the section must be a solicitor or a professional accountant should have had the effect of cutting down on any abuse of the section that may still happen.

15.10 A submission pointed out that a provisional liquidator under section 228A was forbidden by law from selling off the assets of the company except where these were perishable or he obtained leave of the Court and that, if he chose to break the law, he could do so equally in any liquidation.

15.11 The Insolvency Sub-committee is not unanimous about abolishing the section. The majority was of the view that the section was peremptory, debtor led, paralysed creditors with an inability to apply to the court and might cause disputes over fees and disputes over the propriety and conduct of liquidators. It was also questioned why a procedure that on the face of it was more expensive to use than other options would be attractive to responsible directors.

15.12 A minority view was expressed to the effect that it could be useful in the cases of companies which had ceased trading and where the directors had lost interest. By using the provision, the directors could start the winding-up immediately without having to wait for 28 days before a meeting of creditors could be held.

15.13 Submissions on the *Consultation Paper* have, however, indicated a change of view as regards the section. We received quite a number of comments on the section and all but one of these comments were in favour of retaining the section, which represented a reversal of views. The Hong Kong Society of Accountants, for instance, stated that it was now of the view that the section should be retained as it was a useful provision. The submission noted that since the section was tightened up a few years ago, the Society was not aware of any great abuses in practice, even though, conceptually, it was possible to point to potential pitfalls in the procedure.

15.14 A forceful submission disagreed strongly with the suggestion that other provisions in the Companies Ordinance were adequate. The submission said that:

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229 *Re Centrebind Ltd* [1967] 1 WLR 377.

230 See the Insolvency Act, sections 98, 114 and 166.

231 Ordinance No. 75 of 1995.

"...there will in many circumstances be a situation where the directors, who have perhaps gone on a little too long, recognise that there is no future. While frequently the directors can be criticised in that situation, often they are sincerely trying to keep the company afloat and are simply not in command of the true financial position. There is no alternative procedure that works as well in most of these situations. Without the support of the shareholders, perhaps merely because they are absent or overseas, the directors cannot put an insolvent company into voluntary liquidation. This leaves a court application as their only route. This is confusing, slow and expensive. By the time the documents have been prepared, served on the Official Receiver and a Court hearing obtained, which in reality is never going to be put through on an urgent basis for other than the most significant companies, days and perhaps weeks will have gone by. This will inevitably often lead to execution by creditors and in some cases the improper removal or confiscation of the company's property." [232]

15.15 We have taken note of the view of most submissions that the section should be retained. Nonetheless, we **recommend** that the section should be abolished. Our reasons are that it is desirable to cut out any potential within the winding-up provisions for abuse and that, while there has been only anecdotal evidence of abuse, the potential remains while this section is in effect. We also consider that the introduction of a statutory procedure to deregister solvent and defunct private companies, would adequately provide for any situation that might arise and which would not provide a "*grey*" period of time which might be exploited by directors to the detriment of creditors and shareholders.[233]

Penalties under sub-section (2)

15.16 We refer to the recommendation on the penalties that should attach to directors who make a written statement under sub-section (1) without reasonable ground for forming that opinion.[234]

Section 229 Notice of resolution to wind-up voluntarily

15.17 A company shall, within 14 days of passing a resolution for voluntary winding-up, advertise the resolution in the Gazette. The provision is subject to a fine for failure to comply with the requirement.[235]

15.18 The difficulty lies with the 14-day notice period. Practitioners advised that, as the Gazette was only published once a week, on a Friday, advertisements for insertion in the Gazette typically had to be sent to the Government Printer on the Monday morning before publication. If a resolution was made on Thursday, 1 May, it

232 Nelson Wheeler Corporate Advisory Services Ltd.

233 See paragraph 15.6.

234 See paragraph 15.3 under section 228. Note that a failure by a director to comply with any obligation imposed on him by or under section 228A is an applicable matter for determining the unfitness of a director under the fifteenth schedule to the Companies Ordinance.

235 $10,000 plus a daily default fine of $300.

could not be published earlier than Friday, 9 May. This meant that the time period for getting the resolution to the Government Printer was tight, as failure to get the advertisement to the Printer before Monday, 5 May, would see the company leaving itself open to a fine as the next Gazette would not be published until 16 May, 15 days after the date of the resolution.

15.19 Balanced against this is the need for notice of resolutions to be given promptly. We note that section 117 provides that certain resolutions of companies under Part IV of the Companies Ordinance requires that they be filed with the Registrar of Companies within 15 days of the resolution. Under section 253, a liquidator is obliged to publish notice of his appointment in the Gazette within 21 days. Under section 228A(4) directors have 14 days to publish notice of appointment in the Gazette of a provisional liquidator and of the resolution to wind-up a company.

15.20 We **recommend** that notices under this and section 253 should be given within 15 days of the making of a resolution. There is no magic in the number; it just gives those who have meetings late in the working week some breathing space by allowing them to miss one Monday morning deadline without penalty. We can see no reason why the number of days in this section and in section 253 should be different.

15.21 We note one submission which reinforced the argument for 15 days in which to give notice. It does not, however, persuade us to increase the period of notice. The submission stated that sometimes there were exceptional circumstances when it was not possible to comply with even a 15-day deadline:

> "*For instance, in the Easter week, the Gazette deadline is pushed back two days to the Thursday before Good Friday. If one were appointed on the afternoon of the Wednesday before Easter, one could not advertise in the Gazette until 16 days later. Although this sounds absurdly perverse, it almost happened to us a couple of years ago*."

Chapter 16 - Declaration of Solvency

Section 233 Statutory declaration of solvency in case of proposal to wind up voluntarily

16.1 In order for a voluntary winding-up to be a members' (solvent) voluntary winding-up, a declaration of solvency must be made at a meeting of directors within the five weeks preceding the date of, and before, the resolution of the directors for the winding-up of a company. The declaration should be delivered for filing with the Registrar of Companies not later than the date of filing of the resolution to wind-up. If these provisions are not complied with, the winding-up will not be considered to be a members' (solvent) voluntary winding-up and will be treated by the Registrar of Companies as a creditors' (insolvent) voluntary winding-up.

16.2 For directors to make a declaration of solvency, they should have formed the opinion that the company will be able to pay its debts within not more than 12 months from the commencement of the winding-up.

Swearing of the declaration of solvency

16.3 A submission was made that it should be possible to allow the signing of the declaration after the directors' meeting, as opposed to during, but before the subsequent general meeting. The submission also drew attention to the difficulty of securing a statutory declaration in the case of directors who were situated overseas.

16.4 The submission raised a problem of significant practical importance in terms of members' (solvent) voluntary winding-up as, under the provisions, it could be difficult to comply with the provisions and a failure to follow the requirements exactly might result in an intended members' (solvent) voluntary winding-up ending up as what is prosaically known as a " *technical creditors' (insolvent) voluntary winding-up*" .

16.5 The difficulty lies with the requirement under sub-section (1) that the statutory declaration must be sworn by directors at the meeting of directors. This creates a situation where the required number of directors must all be present at the same time to make the declaration. In practical terms, this can create tremendous difficulties for directors, particularly when they are resident in different countries.

16.6 The Registrar of Companies advised that there should be one statutory declaration which would clearly and unequivocally state that all the directors were swearing to the same thing but that, in practice, the Registrar might accept for filing more than one statutory declaration provided they were in identical terms and presented at the same time.

16.7 The swearing of different statutory declarations still leaves open the possibility of mistakes being made, the consequences of which are that, because of a technical mistake, an intended members' (solvent) voluntary winding-up ends up as a creditors' (insolvent) voluntary winding-up.

16.8 We believe that the solution already exists under section 228A(1). This provides that one director can make a statutory declaration verifying the written statements of the other directors and we **recommend** that this procedure should be adopted for declarations under this section subject to the complementary recommendation that directors who make a written statement under this section without reasonable grounds for the opinion stated should also be subject to the penalties imposed by sub-section (3).[236] [237]

16.9 We **recommend** that there should be no requirement that the statutory declaration should be made at the meeting of directors.[238] We **recommend** that the statutory declaration should be set out in standard, though not required, form in the Companies (Winding-up) Rules.

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236 A $50,000 fine and imprisonment.

237 Note the recommendation under paragraph 15.3.

238 The Companies (Amendment) Bill 1999, gazetted on 19 February 1999 proposes that the section should be amended by adding a new sub-section (1A) to the effect that a declaration made under the section may be made other than at a meeting of the directors of the company concerned if, but only if, (i) a resolution had been passed authorising such a declaration to be made and (ii) before the declaration is made.

Chapter 17 - Provisions Applicable to a Members' (Solvent) Voluntary Winding-up

Section 235 Power of company to appoint and fix remuneration of liquidators

17.1 The section provides for the appointment and remuneration of the liquidator or liquidators at the general meeting. It also provides that on the appointment of a liquidator, all the powers of the directors shall cease except so far as the company in general meeting, or the liquidator, sanctions the continuation of the powers.[239]

The "PL formula" to apply to members' (solvent) voluntary winding-up

17.2 We refer to the recommendations on the remuneration of office-holders and on the formation of a Panel to consider the fees of office-holders where the need arises.[240] These recommendations should apply to the remuneration of office-holders in a members' (solvent) voluntary winding-up because, although in a members' (solvent) voluntary winding-up all creditors would have been paid and the question of remuneration would be a private matter between the members of the company and the liquidator, the application of the "*PL formula*" recommended in Chapter 4 would need to be applied in members' (solvent) voluntary winding-up in order that the Panel recommended in Chapter 4 could consider appeals brought before it in a consistent manner. The "*PL formula*" would also provide a better basis on which to consider a liquidator's fees than a time cost basis.

The need for a liquidator in solvent liquidations

17.3 We received a submission that there should be no need for a liquidator in a solvent liquidation. The submission stated that directors should provide written confirmations of solvency and should be subject to criminal sanction and personal liability to creditors if they had no reasonable grounds for their opinion. The commencement of the liquidation should be gazetted, filed with the Companies Registry and perhaps also advertised in a Chinese and an English newspaper as soon as possible. The submission concluded that directors should be obliged to call a creditors' meeting if it appeared at any time subsequently that the company might not be able to pay its debts in full within, say, 12 months, and the provisions for a creditors' (insolvent) voluntary liquidation should thereupon apply.

17.4 We do not support the submission but we record it here as there is much discussion at present on the cost of the winding-up of companies and this would seem to provide for a cheap method of liquidating a company.

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239 A similar provision is made in respect of creditors' (insolvent) voluntary winding-up under section 244(2).

240 See the recommendations on remuneration at Chapter 4.

Section 235A Power to remove liquidator

17.5 The section provides that, in a members' (solvent) voluntary winding-up, the company may by special resolution remove a liquidator at a general meeting, provided appropriate notice of the resolution is given. The court, however, on the application of a creditor or contributory, may order that the liquidator whom it is proposed to remove should not be removed.

17.6 We note that there is no specific provision made in the Ordinance for removal of a liquidator by a meeting called for that purpose by the members. We **recommend** that such a provision should be made and that the Insolvency Act, section 171, which provides that, in a members' (solvent) voluntary winding-up, a liquidator can be removed at a general meeting summoned for that purpose, should be adopted. A similar provision is also made under Insolvency Act, section 171, in respect of a meeting of creditors in a creditors' (insolvent) voluntary winding-up.

17.7 Under the Insolvency Act, section 171, in a members' (solvent) voluntary winding-up or creditors' (insolvent) voluntary winding-up, the liquidator does not need to call a meeting but he may be ordered to do so by the court or, in a members' (solvent) voluntary winding-up, by members representing not less than one-half of the total voting rights of all the members or, in a creditors' (insolvent) voluntary winding-up, by not less than half in value of the creditors.

17.8 The removal of liquidators is provided for under this section in the case of members' (solvent) voluntary winding-up, under section 196(1) in the case of winding-up by the court, and under section 252(2) in both forms of voluntary windings-up.

Section 237 Power of liquidator to accept shares, &c. as consideration for sale of property of company

17.9 The section provides that where, in a voluntary winding-up, the company is to be sold or transferred in whole or in part to another company in consideration of cash, shares in the transferee, or any other form of arrangement, the liquidator requires sanction from either the shareholders in the case of a members' (solvent) voluntary winding-up or the creditors in the case of a creditors' (insolvent) voluntary winding-up. The section, which is under the provisions for members' (solvent) voluntary winding-up, is applied to creditors' (insolvent) voluntary winding-up by section 246.

17.10 In a members' (solvent) voluntary winding-up, a special resolution of members of the company is required. In a creditors' (insolvent) voluntary winding-up, section 246 provides that the liquidator requires either the sanction of the court or the committee of inspection.

17.11 The provision is not used often and we anticipate that the introduction of the recommendations for provisional supervision in the *Report on Corporate Rescue and Insolvent Trading* would be likely to reduce the use of the provision even further.

Section 237A Duty of liquidator to call creditors' meeting in case of insolvency

17.12 The section provides that if a liquidator in a members' (solvent) voluntary winding-up forms the opinion that the company will not be able to pay its debts in full within the period stated in the declaration of solvency under section 233, he must summon a meeting of creditors and lay before it a statement of the company's assets and liabilities.

17.13 At the meeting, the creditors may appoint another liquidator if they wish to but, in any event, the winding-up would, from the date of the meeting of creditors, continue as a creditors' (insolvent) voluntary winding-up.

Provision for rules

17.14 The provision is adequate insofar as it goes but the rules relating to meetings of creditors in the Companies (Winding-up) Rules have not been applied to meetings called under this section.

17.15 The Insolvency Act equivalent provides that a liquidator must summon a meeting not later than 28 days after the day on which he formed the opinion, that notice of the meeting should be sent to creditors not less than seven days before the meeting, that the notice be advertised and gazetted, and that the liquidator should provide creditors with all reasonable information concerning the affairs of the company free of charge.[241]

17.16 The liquidator is also obliged to prepare a statement of affairs in the prescribed form and to lay the statement before the meeting, at which he shall preside. The statement of affairs should contain particulars of the company's assets and liabilities, the names and addresses of creditors and details of any securities held by creditors.[242]

17.17 We **recommend** that the Insolvency Act provisions should be adopted.

Section 238 Duty of liquidator to call general meeting at end of each year

17.18 The section provides that where a liquidation continues for over a year, the liquidator shall summon a general meeting of the company within three months of the end of each year but the Official Receiver may extend the time limit. In the event that a members' (solvent) voluntary winding-up continues for more than a year, the liquidator shall summon a general meeting of the company and lay before the meeting an account of his acts and dealings and of the conduct of the winding-up to date. The Official Receiver may extend the time for the holding of the meeting. If the liquidator fails to comply with the section, he is liable to a fine of $10,000. [243]

241 Insolvency Act, section 95(2).

242 Insolvency Act, section 95(3) and (4).

243 Note that the section is subject to section 239A, which provides that a winding-up which is converted from a members' (solvent) voluntary winding-up to a creditors' (insolvent) voluntary winding-up becomes subject to the provisions governing the latter.

Meeting under the section and General Meeting

17.19 We received a submission that if the final meeting of creditors was to be held pursuant to section 238 within three months of the due date for the annual meeting, section 238 should allow for the annual meeting to be delayed until the final meeting was held. We **recommend** the adoption of this submission as, although the annual meeting is often a paper exercise, the recommendation could save costs in relation to the services of notices of meeting.

Extension of time to be granted by the Official Receiver

17.20 In the consultation process prior to the publication of the *Consultation Paper*, the Official Receiver's Office submitted that the references to the Official Receiver in this section and in section 247 should be replaced by a reference to the Registrar of Companies. The Official Receiver's Office also submitted that the Official Receiver should have no involvement in voluntary winding-up apart from supervising the Companies Liquidation Account.

17.21 While the *Consultation Paper* did not necessarily accept that the role of the Official Receiver should be limited to winding-up by the court and to certain aspects of voluntary winding-up, it proposed that it would be appropriate in this particular case for the Registrar of Companies to deal with extension of time both under this section and under section 247.

17.22 The Registrar of Companies did not agree and submitted that the proposal was illogical given the Official Receiver's role in overseeing section 285 which provided that all unpaid assets which remained in the hands of the liquidator for more than 6 months in both compulsory and voluntary liquidations had to be paid into the Companies Liquidation Account which was administered by the Official Receiver. The Registrar considered that it would be inconsistent for the Official Receiver to oversee section 285 but not sections 238 and 247.

17.23 We accept that the question of an extension of time requires a substantive decision on the part of the Official Receiver and since the Companies Registry is more involved in the mechanical side of the administration of companies it is appropriate that it should be Official Receiver who makes the decision on extension of time.

Section 239 Final meeting and dissolution[244]

17.24 The section provides for the dissolution of a company in a members' (solvent) voluntary winding-up.

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244 We note the comments on the dissolution of companies under section 248, on creditors' (insolvent) voluntary winding-up.

Simplified procedure

17.25 The *Consultation Paper* made a proposal for a new provision which would simplify the dissolution of solvent companies. Events, however, have overtaken this report as the Companies (Amendment) Bill 1999 contains a proposed statutory procedure for the deregistration of solvent and defunct private companies on the initiative of the Registrar of Companies. The proposed procedure would become new sections 291AA and 291AB of the Companies Ordinance and is summarised as follows:

- the company, a director or member of the company and any other interested person, including a liquidator of the company, may apply to the Registrar of Companies for the deregistration of a company;

- an application can only be made if all the members of the company agree to the deregistration, the company has never commenced business or has not carried on business for more than three months immediately before the application and there are no outstanding liabilities;

- the Commissioner of Inland Revenue must have confirmed that he has no objection to the company being deregistered;

- provided the Registrar of Companies is satisfied, without inquiry, that information given by the company is true, the Registrar may publish a notice of the proposed deregistration in the Gazette;

- if no objection is received within three months, the Registrar may deregister the company by declaring it to be deregistered upon the date of publication of a notice in the Gazette;

- a company is dissolved on deregistration;

- the liability, if any, of officers and members continues as if the company had not been dissolved;

- the court may still wind-up a deregistered company;

- any person who knowingly or recklessly gives false or misleading information to the Registrar is liable to a fine and imprisonment;

- if the company is deregistered by the Registrar the Registrar may reinstate the company by publishing a notice in the Gazette;

- the court may order the reinstatement of a company to the Register within 20 years of the deregistration on application by any person who feels aggrieved by the deregistration;

- if the court reinstates a company it may validate anything done between the deregistration and its reinstatement and makes any other appropriate order; and

- these provisions do not apply to companies set out in the 16th Schedule (banking, insurance and other regulated companies).

17.26 For the purposes of completeness, we record the detailed submission on a simplified procedure that was received from the Hong Kong Institute of Company Secretaries. The Hong Kong Institute of Company Secretaries submitted that:

> *"The formal means by which a company incorporated under the Companies Ordinance may cease to exist is that of dissolution. Prior to dissolution, the Ordinance requires an orderly winding-up of the company's affairs, realisation of assets, settlement of creditors' claims, return of paid up capital and distribution of any surplus to shareholders. Part V of the Ordinance is concerned with these objectives.*
>
> *It should be remembered that Part V deals with the winding-up of all companies incorporated under the Companies Ordinance, i.e. companies limited by shares, limited by guarantee and unlimited companies. Moreover, it should be remembered that the vast majority of companies wound-up are small private companies which have outlived their usefulness, and not the larger, public companies for which the provisions were undoubtedly first designed. Our comments are given in the context of the small, private company where the only creditors are likely to be the Inland Revenue and the shareholders, where shareholders are rarely more than five in number and where the costs of Gazetting will alone exceed the net available assets and so require continued shareholder support if the company is to avoid the even more complicated and expensive situation of a creditors' voluntary liquidation. The Commission will no doubt be aware that many advisers (and some company law academics) openly propose that in the case of modestly capitalised and barely solvent companies the directors should instead petition the Registrar of Companies to use his discretionary powers under section 290A and 291.*
>
> *Whereas the Ordinance provides an efficient means of incorporation, Part V fails to provide an expedient means of permitting the winding-up and dissolution of solvent companies. We feel that it should. Problems include (a) the difficulty of securing a statutory declaration (as defined) in the case of a majority of directors situated overseas, (b) inadvertently filing a statutory declaration after the notice of general meeting resolutions and creating what the Registrar terms as a 'technical creditors' voluntary winding- up'. Furthermore, there is no clear indication as to a dissolution date, a fact which is in turn sometimes responsible for inadvertent breaches of section 158(4) in the case of directors of listed companies. Finally, the required wording of general meeting resolutions is such that the cost of advertising required notices in the Gazette is, in many cases, a complete waste of money. It should be remembered that the text of resolutions and notices is almost identical in every case, and presented in a manner which is hardly conducive towards helping creditors."*

17.27 We generally supported the Institute's submission, subject to the comments set out below.

17.28 The Institute submitted suggestions for a simplified procedure for dissolution in the following terms:

- directors should draw up a statement of assets and liabilities, reducing all assets to cash balances;
- directors should settle all creditors' claims and reduce the balance sheet total to zero;
- directors should secure Inland Revenue clearance;
- directors should certify under oath that remaining assets comprise cash alone, that the net assets do not exceed the amount of paid-up capital and stating their intention to recommend to the members that the company be wound-up and dissolved,
- directors should file the same with the Registrar of Companies, who should notify the same in the Gazette by way of reference only, for the protection of creditors generally;
- the Gazette to list such notifications in alphabetical order;[245]
- creditors should have one month in which to object to the proposed winding-up; and
- directors should resolve to wind-up, return capital to shareholders and file notification with the Registrar of Companies who should, upon receipt, dissolve the company and notify the same in the Gazette, again by way of alphabetical listing.

17.29 The *Consultation Paper* proposed that the Institute's submission should be adopted on the basis that it would satisfy the requirement that the claims of creditors would be satisfied and for the proper dissolution of the company. The *Consultation Paper* noted that a problem might need to be overcome in that the Registrar of Companies might take the view that he should not have to pay costs of gazetting the dissolution. To overcome this the *Consultation Paper* proposed that the costs of gazetting the dissolution could be included in the dissolution fee that would have to be paid by the directors.

17.30 We suggest that the second condition of the procedure, that the directors settle all creditors' claims and reduce the balance sheet total to zero, is unnecessary. The condition should simply be to the effect that all liabilities have been discharged.

17.31 We would put down a marker about the intention behind the fourth condition of the simplified procedure. The requirement that net assets do not exceed the amount of paid up capital is important as it sets the criterion under which the procedure could operate. Paid up capital could range from $2 to any figure one can imagine. We wonder whether the Institute's simplified procedure could or should be applied by large or very large companies or whether there should be some cut off in

245 Note the recommendations under Chapter 29.

terms of the underlying value of companies beyond which companies could not avail of the procedure.

Inland Revenue

17.32 The *Consultation Paper* noted that the only significant obstacle to an efficient usage of a simplified procedure was the considerable delay experienced in securing clearance from the Inland Revenue Department. The *Consultation Paper* noted Inland Revenue Department' s advice that section 51C of the Inland Revenue Ordinance required that a taxpayer should retain business records for seven years after the completion of the transactions to which the records relate. As the law stands, however, there is no requirement for liquidators to seek tax clearance from the Inland Revenue Department before they wind-up the affairs of companies. The problem for liquidators is that if the tax clearance certificate is delayed for more than six months after the receipt of money the liquidator must pay the money into the Companies Liquidation Account operated by the Official Receiver under section 285.

17.33 The Commissioner of Inland Revenue stated that in most cases he was not interested in dissolved companies as their tax liabilities had usually been cleared. In rare cases, however, where the liquidator dissolved a company with outstanding or potential tax liabilities, the Commissioner had a right to reinstate the dissolved company under section 209 of the Companies Ordinance. Upon reinstatement, the company would be regarded as having not been dissolved and section 51C would then continue to apply to it.

17.34 The *Consultation Paper* commented that the Commissioner' s comments, however, were likely to be of little comfort to a liquidator as he could not be sure that the company he was liquidating was not going to attract the attention of the Commissioner and that he had to therefore obtain a tax clearance certificate.[246]

17.35 In response to the *Consultation Paper*, the Commissioner stated that it depended very much on the co-operation of the liquidator in submitting in good time the tax return and required information for the determination of the proper tax liability of the company, particularly for those cases involving objections to tax assessments.[247]

17.36 While we accept the point, we cannot but comment that this is not a matter that can be legislated for as it is not feasible to put deadlines on the issuance of tax clearance certificates nor is there any date on which to fix a time limit in which a liquidator must apply for a certificate. Clearly, liquidators can help themselves by submitting a return in good time. We also understand that it can still take a long time to obtain a certificate after a return has been made. In this context, the Commissioner for Inland Revenue might be able to provide an initiative in terms of his performance pledges.

Books to be kept

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[246] See the comments under section 217, at paragraph.14.49.

[247] Note the comments of the Commissioner of Inland Revenue at section 283, paragraphs 23.20 to 23.30.

17.37 The Hong Kong Institute of Company Secretaries made reference to contradictions in legislation in relation to the keeping of books. We have commented on the point under section 283.

Declaration of solvency

17.38 The Institute referred to the declaration of solvency in its submission. We have addressed the points in the recommendations under section 233.

Advertising of notice in the Gazette

17.39 We have made recommendations as regards the advertising of notices in the Gazette in Chapter 29. The recommendations would apply to notices under this provision.

Post dissolution

17.40 The Institute submitted that the position and duties of liquidators after dissolution should be set out clearly and that the common law guidelines should be adopted into the Ordinance to assist liquidators. We do not support this suggestion as we consider that it would be a case of over-legislating.

Affairs of the company fully wound-up

17.41 We note the recommendation under section 248, which would equally apply to this section. [248]

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[248] See paragraph 18.31.

Chapter 18 - Provisions Applicable to a Creditors' (Insolvent) Voluntary Winding-up[249]

Section 241 Meeting of creditors

18.1 The section provides that a meeting of creditors shall be held on the day of, or the day after, the meeting of the company to resolve that the company should be wound-up voluntarily. Notice of the meeting of creditors should be sent personally to creditors and notice should also be advertised in the Gazette.[250]

18.2 The directors are obliged to provide a statement of affairs to the meeting of creditors which should contain a list of creditors and the amounts of their claims.[251]

18.3 If the meeting of the company at which the resolution for voluntary winding-up is adjourned, and the resolution is passed at an adjourned meeting, any resolution passed at the meeting of creditors held before the adjourned meeting of the company shall have effect as if it had been passed immediately after the passing of the resolution for winding-up the company.[252] The provisions are subject to penalties being imposed on the company or the directors if the provisions are not complied with.[253]

Consequences of adjourned meeting of company

18.4 The Hong Kong Society of Accountants submitted that, under sub-section (5):

> *" …if the meeting of the company at which the resolution for voluntary winding-up is to be proposed is adjourned and the resolution is passed at an adjourned meeting, any resolution passed at the meeting of the creditors held in pursuance of sub-section (1) shall have effect as if it had been passed immediately after the passing of the resolution for winding-up the company. It appears from sub-section (5) that it may be in order to hold a meeting of a company's creditors under section 241 before a winding-up resolution is passed by the company's members. We consider it inappropriate to hold a section 241*

249 See the recommendation on the renaming of members' (solvent) voluntary winding-up in Chapter 6.

250 Sub-sections (1) and (2).

251 Sub-section (3).

252 Sub-section (5).

253 Under sub-section (6) a fine of $50,000 may be imposed. Note that a failure by a director to comply with any obligation imposed on him by or under section 241 is an applicable matter for determining the unfitness of a director under the fifteenth schedule to the Companies Ordinance.

creditors' meeting before the members have passed the winding-up resolution and considered the nomination of a liquidator.

If the members' meeting (at which the winding-up resolution is to be passed) is adjourned, we suggest that the creditors' meeting be adjourned to be held after the adjourned meeting of members, but on the same or next day. It is noted that a company only goes into liquidation when a members' resolution for its voluntary winding-up is passed; it would be incorrect to hold a creditors' meeting and pass resolutions on the assumption that the resolution for winding-up would be passed. Additionally, from our members' experience, there is apparently little or no practical use for section 241(5) and accordingly we suggest that it be repealed."

18.5 The situation envisaged by the Society would be a rare event. It is clear that it would be inappropriate for the meeting of creditors to be held before the meeting of the company. We consider that if that were to happen, the meeting of creditors could not transact any business in such circumstances.

18.6 We **recommend** the adoption of the corresponding Insolvency Act provision which provides that the company shall summon a meeting of creditors for a day not later than the fourteenth day after the day on which there is to be held the company meeting at which the resolution for voluntary winding-up is to be proposed.[254] This provision replaced a provision which mirrored the situation that prevails under section 241.

18.7 In addition, we **recommend** that the powers of directors to act during the period between the meeting of the company and the meeting of creditors should be restricted. In this regard, provisions of the Insolvency Act should be adopted which restrict the powers of directors to preserving the assets of the company until a liquidator is appointed.[255] We note that this provision has a weakness in that it only applies after a voluntary winding-up has commenced and that the directors would still have control of the company in the time before the meeting of the creditors' is convened. The *Cork Report* had recommended that a voluntary winding-up should commence as soon as the directors had decided that, because of its liabilities, a company could not continue in business and that the directors should immediately appoint a provisional liquidator who would take control of the company and preserve the company's position until the meeting of creditors appointed a liquidator.[256] It may be that that would be a more appropriate way to proceed than by adopting the Insolvency Act, section 114.

Details of the statement of affairs

18.8 Although sub-section (3) provides that the statement of affairs shall contain a list of creditors and the amounts owed to them, we **recommend** that the statement should be in the prescribed form under the Companies (Winding-up) Rules, form 23. This would provide creditors with the same comprehensive form of statement that would be prepared by a company in a winding-up by the court.[257]

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254 See the Insolvency Act, section 98.

255 See the Insolvency Act, section 114.

256 See the *Cork Report*, paragraphs 666 to 673.

257 Note that the Insolvency Act, section 99, makes similar provision.

18.9 We received two submissions which stated that form 23 was in need of revision. We are advised by the Official Receiver's Office that form 23 and other winding-up forms have recently been reviewed and amended.

Section 242 Appointment of liquidator

18.10 The section provides for the appointment of a liquidator at the respective meetings of the creditors and the company. The person nominated by the creditors shall have priority but there is also provision for application to the court by any director, member or creditor of the company if that person wants the person nominated as liquidator by the meeting of the company to be made liquidator.

18.11 In a submission made prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *"Section 228A has been amended by the insertion of sub-section 228A(3C) which reads;*
>
> *'No person should be appointed to be a provisional liquidator under sub-section (3)(b) unless he has consented in writing to such appointment, and he is a solicitor, or a professional accountant under the Professional Accountants Ordinance (Cap. 50).'*
>
> *However, this qualification requirement, presumably inserted to ensure that provisional liquidators are competent and have knowledge of the law in Hong Kong relating to liquidators, was not repeated in section 242 which deals with the appointment of a liquidator in creditors' voluntary windings-up. Thus, although it is necessary for the provisional liquidator in a section 228A liquidation to be either a solicitor or an accountant as defined, anyone can be appointed as liquidator. In addition, the insertion of sub-section 228A(7A) now precludes provisional liquidators from selling property, leaving this power to the subsequently appointed liquidator. It is equally important that the liquidator appointed under section 242 be qualified in the same way as the provisional liquidators appointed under section 228A.*
>
> *Although the majority of creditors by value, present in person or by proxy at the creditors' meeting can nominate the liquidator, it would be possible for some, or all, of the creditors to be severely disadvantaged if the liquidators were unqualified people. In cases where there is a substantial overseas creditor, it is likely, and it would be possible for him to appoint persons from his own jurisdiction, who may not have any understanding of Hong Kong insolvency law and practice, and who may either be unaware of their obligations under the Companies Ordinance in respect to the filing of documents at the Companies Registry and of their obligation to place undistributed monies on deposit with the Official Receiver, or not be prepared to fulfil these requirements. We believe it is necessary to remedy these deficiencies as soon as possible, and propose that a professional qualification requirement, similar to section 228A, be imposed for all liquidator's appointments, so that only solicitors, professional accountants,*

and members of similarly regulated professions shall be eligible for appointment as liquidators."

18.12 We agree that the amendment has probably not fulfilled all that was intended of it and that, by not requiring that a liquidator should also be a qualified solicitor or accountant, the amendment has not reduced the potential for abuse as much as it might have. We **recommend** that section 228A(3C)(b) should be applied to the appointment of a liquidator under this section. We note that we have recommended that only appropriately qualified and recognised professionals should be appointed as liquidators.[258] The Society's submission tends to support the recommendations for a comprehensive system of insolvency practitioners to be instituted. Such a scheme would provide for the points raised by the Society.

Section 243 Appointment of committee of inspection

Number of members of the committee of inspection

18.13 In a submission made prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *"The provisions relating to the maximum size of the committee of inspection are ambiguous. It is not clear from section 243 of the Ordinance whether the maximum number of members on a committee should be five or 10 (i.e. a maximum of five from creditors and another five from members) in a voluntary liquidation. Under section 207 of the Ordinance, there is no limit in a court liquidation."*

18.14 While it is likely that the section contemplated as many as ten members on a committee, the Society is correct in asserting that the position is not clear. We have recommended, under section 207, that there should be a maximum of seven members on a committee and we **recommend** that this should also apply to committees appointed under this section. We note that, under sub-section (1), if contributories resolve to appoint five representatives to the committee, the creditors can resolve to reject them, at which point the court may be called upon to resolve the issue. Creditors are therefore adequately protected.

Committee of inspection to act in the best interests of creditors as a whole

18.15 The Hong Kong Society of Accountants also submitted, prior to the publication of the *Consultation Paper*, that:

> *"Any procedures specified should ensure that all appointments by creditors to the committee are not controlled by a creditor or group of creditors with a majority in value of claims. In this regard the extent to which related individuals or group companies can participate in voting for committee members should also be considered."*

18.16 The *Consultation Paper* sympathised with the submission but was concerned that it might be difficult to provide for as the nature of the business environment in Hong Kong, with its proliferation of connected businesses, particularly

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258 Note the recommendations on the licensing of insolvency practitioners under Chapter 3.

family connections, meant that the potential for a body of creditors, representing a particular interest group, taking control of a committee, was not all that remote. The *Consultation Paper* noted situations where committees pursued sectional interests rather than representing the interests of all the creditors.

18.17 The *Consultation Paper* did not make a proposal but asked for submissions on the idea that the Ordinance could contain a statement that the general duty of the members of the committee should be to act in the best interests of all the creditors. Such a statement could be supported by specifically providing in section 255 that liquidators would have the right to apply to the court for directions at any time if it became clear that a committee was not acting in the best interests of all the creditors. The provision could also apply to section 207.

18.18 Two submissions were made on this question and we take the point made in one that the committee should act in the interests of the creditors as a whole rather than in the interests of all the creditors. We **recommend** the adoption of such a provision.

18.19 We note, however, the other submission that great care should be taken before imposing a statutory duty on the members of a committee of inspection as the risk arises that minority creditors or disgruntled contributories might attempt to launch proceedings against members of a committee if they believed they had suffered loss as a result of the committee's actions. The submission continued that if the risk of being sued was a real one, it would be highly unlikely that creditors could be found to join a committee at all. The submission admitted that any duty on the committee could be worded expressly so as to give rise to no private right of action, but that the provision then became a bland statement of principle with no force. The submission suggested that the only practical course was to give the liquidator power at any time to seek the court's directions if the committee either would not make a decision or the committee was acting in a way the liquidator believed was contrary to creditors' interests.

Recommendations under section 207

18.20 We refer generally to the recommendations under section 207, all of which would apply to this section.

Section 244 Fixing of liquidators' remuneration and cesser of directors' powers[259]

18.21 Sub-section (1) provides that the committee of inspection, or if there is no committee, the creditors, may fix the remuneration of liquidators. Sub-section (2) provides that on the appointment of a liquidator, all the powers of the directors shall cease, except so far as the committee of inspection, or the creditors if there is no committee, sanction the continuance of powers.

Remuneration and cesser of powers to be separated

[259] The *Consultation Paper*, paragraphs 13.19 to 13.24, made reference to the remuneration of liquidators in a creditors' (insolvent) voluntary winding-up. These comments are now superseded by the recommendations under Chapter 4.

18.22 This is another section which unfortunately applies two different concepts. We **recommend** that the issues of remuneration and the ceasing of directors' powers should be contained in separate sections. [260]

Section 245 Power to fill vacancy in office of liquidator

18.23 The section provides that if a vacancy occurs, by death, resignation or otherwise, in the office of a liquidator, other than a liquidator appointed by, or by the direction of, the court, the creditors shall fill the vacancy. No express provision appears to be made in the Ordinance for the resignation of a liquidator in a creditors' (insolvent) voluntary winding-up.

18.24 The Companies (Winding-up) Rules, rule 154, however, provides that a liquidator who wants to resign should call separate meetings of creditors and contributories to decide whether or not his resignation should be accepted. If it is accepted, the liquidator shall give notice of the resignation to the court and a copy of the notice to the Official Receiver at which time the resignation shall take effect. If the resignation is not accepted by the meetings, the liquidator may apply to the court for a determination whether or not the resignation should be accepted and to give appropriate directions.

18.25 It is not clear from the Companies (Winding-up) Rules whether rule 154 applies to creditors' (insolvent) voluntary winding-up. We **recommend** that this rule should be adapted for the purposes of creditors' (insolvent) voluntary winding-up but that the notice should be filed with the Registrar of Companies, not with the court.

Section 247 Duty of liquidator to call meetings of company and of creditors at end of each year[261]

Discretion to postpone holding of meetings for up to three years

18.26 Prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *"The section should be amended to allow the Official Receiver to exercise discretion to cancel the meetings of creditors and contributories (or one of them) when it is clear that there will not be any return to contributories or the costs of convening these meetings are commercially not justifiable."*

18.27 The *Consultation Paper* agreed with the submission and proposed that the Official Receiver should have the power to dispense with meetings of creditors and contributories in appropriate circumstances subject to there being a meeting at the end of three years if no meeting had been held in the period.

[260] See section 196.
[261] We refer to the recommendations under section 238. See paragraphs 17.18 to 17.23.

18.28 We received a submission which considered the proposal to be a dangerous precedent. The submission stated that while it accepted that there was no benefit in holding a meeting of contributories in many cases and no reason for not dispensing with this with the sanction of the Official Receiver, this was far from true for meetings of creditors because, as creditors had lost their money, they should be entitled to a say. The submission felt that the proposal was geared to allowing a liquidator to avoid answering difficult questions and, particularly where there was a committee of inspection, it could easily be seen as establishing too cosy a relationship.

18.29 We accept the submission and amend the proposal in the *Consultation Paper* to **recommend** that in the interests of accountability and transparency the section should be retained as it is.

Section 248 Final meeting and dissolution

18.30 The section provides for the dissolution of a company in a creditors' (insolvent) voluntary winding-up.

Affairs of the company fully wound-up

18.31 We consider that the reference in sub-section (1) to the affairs of the company being " *fully wound-up*" does not reflect the fact that in many cases there are loose ends in a liquidation that cannot be reconciled with the idea of a company being fully wound-up. We **recommend** that the position in practice would be better reflected by use of wording taken from section 205(1) to the effect that a company may be dissolved once the liquidator " *has realised all the property of the company, or so much thereof as can, in his opinion, be realised without needlessly protracting the liquidation.*" This would also apply to the corresponding provision in respect of members' (solvent) voluntary winding-up under section 239(1).

18.32 The Commissioner of Inland Revenue expressed concern at the recommendation and was of the view that the recommendation had not covered the full duties of a liquidator:

> " *The mere emphasis put on the asset side of a company in liquidation is insufficient. For example, a company may have an unsettled objection being pursued under the objection and appeal machinery of the Inland Revenue Ordinance. Similarly, there may be other claims or pending litigations notwithstanding that all the assets of the company have been realised. The outcome of such a recommendation is likely to be more aggrieved creditors.*"

18.33 The Commissioner therefore suggested the retention of the existing provision which he considered to be more appropriate in reflecting the idea of a company being wound-up. We, however, remain of the view that the recommended wording is more appropriate.

Chapter 19 - Provisions Applicable to Every Voluntary Winding-up

Section 250 Distribution of property of company

19.1 The section provides that, apart from the provisions for preferential payment of debts in section 265, the property of a company shall, on winding-up, be applied in satisfaction of its liabilities *pari passu*.[262] Subject to that, unless the articles of the company provide otherwise, the property of the company shall be distributed among the members according to their rights and interests in the company.

19.2 We consider that the intention behind this provision has been lost due to the increasing number of preferences provided for in section 265. We **recommend** that the section should be moved to form a new sub-section (1) of section 265 so as to make clear that the preferences contained in section 265 are exceptions to the principle of *pari passu* distribution.

Application to winding-up by the court and creditors' (insolvent) voluntary winding-up

19.3 In a submission made prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *"Section 250 is applicable to voluntary windings-up only….In practice, the pari passu principle is also applicable to a winding-up by the court. We therefore propose that the statutory application of the 'pari passu' principle be extended to compulsory windings-up. This would serve as another example of provisions that could be considered for common application to all modes of liquidation."*

19.4 The *Consultation Paper* proposed that the section should apply to all forms of winding-up and, subject to the proposal that the section should be moved to form a new section 265(1), it was also proposed that the provision should be placed with those provisions which were applicable to every mode of winding-up.

19.5 A submission pointed out that in a members' (solvent) voluntary winding-up everyone was paid in full and it was meaningless to provide that the *pari passu* principle applied. We take the point and **recommend** that the provision should only apply to winding-up by the court and creditors' (insolvent) voluntary winding-up.

Section 251 Powers and duties of liquidator in voluntary winding-up

[262] We have noticed that the Chinese definition of *pari passu* under section 250 means "*rank equally and at the same time*", which accords with the definition of *pari passu* used in the Bankruptcy Ordinance. All other reference to *pari passu* in Chinese in the Companies Ordinance is defined as "*rank equally*".

Powers of liquidator

19.6 This section sets out the powers of a liquidator in a voluntary winding-up by reference to section 199, which provides for the powers of a liquidator in a winding-up by the court.

19.7 We note that it is recommended that the powers of all liquidators, including the powers of liquidators in voluntary windings-up, should be placed together in a schedule to the Ordinance.[263]

Duties of liquidator

19.8 We refer to the recommendations on the duties of liquidators under section 200.[264] The recommendations would equally apply to liquidators in voluntary windings-up as it would to the duties of a liquidator in a winding-up by the court.

Section 253 Notice by liquidator of his appointment

19.9 We refer to the recommendation, explained in the comments under section 229, that notices under this section and section 229 should be given within 15 days of the making of a resolution.[265]

19.10 We received a submission that a liquidator was, strictly speaking, required to publish notice of his appointment in the Gazette in the same format as the form that he filed with the Companies Registry. The form prescribed contained the liquidator' s identity card number. The submission suggested that the requirement to give an identity card number be dropped in respect of the Gazette notice and, ideally, also from the Companies Registry' s requirements as there were other ways of identifying the liquidator if needed be.

19.11 We agree with this submission. There is no good reason as to why a liquidator should have to disclose his identity card number in a Companies Ordinance form and certainly not in the Gazette. Apart from all other considerations, insolvency practitioners are professionals and officers of the court and should not be subjected to the creeping practice of producing identity card numbers.

Section 254 Arrangement, when binding on creditors

19.12 The section provides that any arrangement entered into between its creditors and a company which is being wound-up, or about to be wound-up, shall be binding on the company if sanctioned by a special resolution of the company, and shall be binding on the creditors if acceded to by three-quarters in number and three-quarters in value of the creditors. Any creditor or contributory who objects to the arrangement may appeal to the court within three weeks from completion of the arrangement.

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263 See section 199 at paragraph 12.48.
264 See paragraph 12.53.
265 See paragraph 15.20.

Challenge within 14 days from the date of the arrangement

19.13 We received a submission that it would be preferable to require any challenge to be made within a period counting from the date of the relevant meeting of creditors or contributories, and in the interests of an arrangement which had been approved, it was submitted that a period of two weeks thereafter would suffice.

19.14 We are not in favour of having two different time frames within which to challenge an arrangement that has been agreed. We are concerned, however, that the present provision provides for a challenge within three weeks of completion of the arrangement. This tends to imply that the challenge could come after the terms of the arrangement had been carried out. We consider that the challenge should be linked to the date the arrangement was entered into. We therefore **recommend** that any challenge should be made within 14 days from the date the arrangement was entered into.

19.15 The 14 days should give all creditors, even those not resident in Hong Kong, time to prepare a challenge.

Resolution to be passed by majority in number and two-thirds in value

19.16 In its *Report on Corporate Rescue and Insolvent Trading*, the Commission recommended that for a proposal put to creditors for a voluntary arrangement under the recommended provisional supervision procedure, a majority in number and two-thirds in value of creditors present at the meeting should be required for a vote in favour of the proposal.[266] The Commission considered that, while it did not favour a bare majority of creditors being able to alter the rights of creditors, a requirement for three-quarters in value could discourage those who were trying to put an arrangement in place. The Commission was of the view that a majority in number and two-thirds in value of creditors represented a convincing level of acceptance by creditors. We maintain this view and **recommend** that the section should be amended to the effect that a majority in number and two-thirds in value of creditors present at a meeting of creditors should be required for a proposal to be accepted.

19.17 We received a submission that a resolution should be carried by 50 per cent in value. We also wish to record that a minority of members of the Insolvency Sub-committee held the view that the three-quarters in number and value provision should be retained as there is no court supervision of an arrangement made under this section.

Section 255A Audit of liquidator's accounts in voluntary winding-up

19.18 Sub-section (1) provides that the liquidator shall keep an account of his receipts and payments as liquidator and, subject to sub-section (2), cause the account to be audited. Sub-section (2) provides that an audit may not be required if the committee of inspection or, where appropriate, the company by ordinary resolution, so determines.

[266] See the *Report on Corporate Rescue and Insolvent Trading*, paragraphs 16.35 to 16.37.

19.19 In a submission prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *"Section 255A(2) of the Ordinance states that an audit under this section shall not be required if the committee of inspection or, as the case may be, the company by ordinary resolution, so determines. It is not clear who should decide whether or not an audit is required in a creditors' voluntary winding-up where there is no committee of inspection. It would seem logical for a decision on the audit requirement to be made, in the case of a creditors' voluntary winding-up, by the committee of inspection or, if there is no such committee, by a meeting of the creditors, and, in the case of a members' voluntary winding-up, by the company by ordinary resolution. Consideration should be given to expanding section 255A to specify who should perform the audit of the liquidator's account, if one is to be carried out, and who should pay for it."*

19.20 We understand that, in practice, the resolution to wind-up a company invariably makes provision for the audit to be dispensed with. In our view, the cost of the audit would be an expense of the company and should be paid for out of the assets of the company under section 256.

19.21 It would be useful for the sake of clarity, however, to make specific provision for an audit and we **recommend** that the Society's submission that in a creditors' (insolvent) voluntary winding-up, the committee of inspection, or a meeting of creditors if there is no committee, and in a members' (solvent) voluntary winding-up, the company by ordinary resolution, should decide on whether an audit is required.

Section 257 Saving for rights of creditors and contributories

19.22 The section provides that the winding-up of a company shall not bar the right of any creditor or contributory to have it wound-up by the court. In the case of an application by a contributory, the court must be satisfied that the rights of the contributories would be prejudiced by a voluntary winding-up.

Deeming provision in relation to creditors' (insolvent) voluntary winding-up for the purposes of the Protection of Wages on Insolvency Ordinance

19.23 In practice, the section is now used as a means whereby employees in a creditors' (insolvent) voluntary winding-up case can apply to the Director of Legal Aid to petition to wind-up a company by the court. When the petition is filed, the employees then qualify for an *ex-gratia* payment out of the Protection of Wages on Insolvency Fund and the petition is then stayed by order of the court so as to enable the voluntary winding-up to continue.[267]

[267] *Re Rena Gabriel H. K. Ltd* [1995] 2 HKC 273.

19.24 We received submissions which expressed dissatisfaction with the process under which it was often necessary for employees to present a petition in order to enable payments to be made to them under the Protection of Wages on Insolvency Ordinance (Cap. 380). One submission concluded that this matter should be addressed so that unnecessary petitions did not have to be presented if a creditors' (insolvent) voluntary winding-up was already in process. Another submission suggested that one solution might be to include a section in the Companies Ordinance to allow a petition for winding-up by the court, notwithstanding the fact that a creditors' (insolvent) voluntary winding-up was in progress.

19.25 We are concerned that public money and time is being wasted unnecessarily. When a company gets into trouble and a receiver is appointed over its assets or a liquidator is appointed in a creditors' (insolvent) voluntary winding-up, employees who are concerned that their salaries and other statutory entitlements will not be paid find that they cannot avail of the statutory benefits under the Protection of Wages on Insolvency Ordinance because section 16 of that Ordinance requires a petition to wind-up the company by the court to have been presented before an *ex gratia* payment can be made from the Protection of Wages on Insolvency Fund.

19.26 This leads to the convoluted situation where employees go to the Legal Aid Department to obtain legal aid to help them file a petition to wind-up the company. A petitioner' s deposit must then be paid to the Official Receiver who must then set in train a series of procedures. Lawyers for the Director of Legal Aid and the Official Receiver then appear in court on the hearing of the winding-up petition in the full knowledge that it is now the court' s practice to stay the petition so as to enable the voluntary winding-up to continue. No winding-up order is therefore made but the provisions of section 16 of the Protection of Wages on Insolvency Ordinance are satisfied and the Protection of Wages on Insolvency Fund Board feels free to make an *ex gratia* payment.

19.27 We suggest that the obvious solution is that the Protection of Wages on Insolvency Ordinance should be amended to allow *ex gratia* payments to employees other than when a petition for winding-up by the court has been presented but it is not within our terms of reference to make recommendations on the Protection of Wages on Insolvency Ordinance.

19.28 If the Protection of Wages on Insolvency Ordinance is not amended the same effect may be achieved by the adoption into the Companies Ordinance of a provision that, if where a creditors' (insolvent) voluntary winding-up is in progress, upon the Director of Legal Aid giving notice to that effect to the liquidator in the creditors' (insolvent) voluntary winding-up, the liquidation should be deemed to be a winding-up by the court for the purposes of the Protection of Wages on Insolvency Ordinance but not otherwise.

19.29 We **recommend** that the Companies Ordinance should be changed in this way if the Protection of Wages on Insolvency Ordinance is not amended as suggested.

Filing of accounts of liquidator on conversion from voluntary winding-up to winding-up by the court

19.30 We received a submission prior to the publication of the *Consultation Paper* from the Hong Kong Society of Accountants that there was no clearly defined practice for filing accounts (the relevant date of filing as well as the period to be covered) in the event of a conversion from a voluntary winding-up to winding-up by the court. The submission stated that it was not clear whether the liquidator appointed

under a voluntary winding-up should prepare accounts up to the date of his ceasing to act as liquidator in the voluntary liquidation, the date of the court winding-up order or the date of appointment of the liquidator by the court.

19.31 The Hong Kong Society of Accountants added that in the event of a conversion, the date of the cessation of the term of office of the liquidator in the voluntary winding-up was not clear. Sections 236, 245 and 252 of the Companies Ordinance set out the circumstances where liquidators in voluntary liquidations might be removed. They did not provide for conversions to winding-up by the court. Hence, unless the relevant winding-up order or the order appointing the court appointed liquidator specifically provided also for termination of office of the "voluntary" liquidator, it was not clear when the "voluntary" liquidator's office was terminated. The submission concluded that, in practice, there was an ambiguity which could be confusing for insolvency practitioners.

19.32 We agree with the submission that the position needs clarification and **recommend** that the powers of the liquidator appointed in a creditors' (insolvent) voluntary winding-up or a members' (solvent) voluntary winding-up should cease on the date of the order converting the voluntary winding-up into a winding-up by the court. This would mean that on the making of a winding-up order a liquidator under the voluntary winding-up would cease to act and he should file accounts up to the date of the winding-up order.

19.33 The Hong Kong Society of Accountants also stated that if the court appointed the liquidator in the voluntary winding-up to continue as liquidator after the conversion, it was unclear whether this change in capacity would require the person concerned to file accounts in these two different capacities; that was, in his capacity as liquidator under the voluntary winding-up, according to rule 181 of the Companies (Winding-up) Rules, and in his subsequent capacity as liquidator in the court-ordered winding-up, in accordance with rule 162(1).

19.34 We **recommend** that if a "voluntary" liquidator wants to take advantage of the provisions of section 205 of the Companies Ordinance he should be required to file accounts up to the date of the winding-up order even though he is then immediately appointed as liquidator in the winding-up by the court.

Chapter 20 - Proof and Ranking of Claims

Section 263 Debts of all descriptions to be proved
Section 264 Application of bankruptcy rules in winding-up of insolvent companies

20.1 Section 263 provides that, subject to the provisions on winding-up by the court under section 264, the section applies to every winding-up. All debts payable on a contingency, and all claims against the company, present or future, certain or contingent, ascertained or subject to a claim for damages, shall be admissible to proof against the company. A just estimate shall be made, so far as possible, of the value of such debts or claims as may be subject to any contingency or to a claim for damages, or which for some other reason do not have a quantifiable value.

20.2 Section 264 applies the bankruptcy rules to the winding-up of insolvent companies in relation to the rights of secured and unsecured creditors, to debts provable and to the valuation of annuities and future and contingent liabilities.

20.3 The Hong Kong Society of Accountants submitted that:

> *"... in the context of proofs of debt, section 264 of the Ordinance refers to the Bankruptcy Rules without setting out the corporate equivalent of an act of bankruptcy[268]. Such cross referencing to another legislation should not be used. Another example is the uncertainty surrounding the corporate equivalent of a receiving order."*

20.4 The Hong Kong Association of Banks submitted that:

> *"It has been suggested that the provisions of the Companies Ordinance which cross-refer to the Bankruptcy Ordinance should be codified into a single enactment dealing with company liquidations, thereby avoiding the need to cross-refer to another Ordinance. On balance we would resist this as unnecessary duplication with the danger of the provisions becoming out of synchronisation."*

20.5 We have recommended that the winding-up provisions of the Companies Ordinance, the provisions on receivership under the Companies Ordinance, the provisions on provisional supervision, when they are introduced, and the Bankruptcy Ordinance should be combined in one Ordinance.[269]

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268 Acts of bankruptcy were abolished consequent to amendments to the Bankruptcy Ordinance in the Bankruptcy (Amendment) Ordinance 1996, which came into effect on 1 April 1999.

269 See Chapter 2.

20.6 We consider that, since the *Review of the Hong Kong Companies Ordinance* has made a recommendation along similar lines, it is likely that a separate Ordinance, perhaps called the Insolvency Ordinance, will be introduced.

20.7 If that is the case, the opportunity should be taken in the drafting process to review all the rules relating to each insolvency procedure and to apply those rules that are compatible to other procedures where possible. Obviously, the fewer provisions there are the easier the Ordinance will be to understand. We have found, however, that while some rules relating to a particular process, such as the presentation of a petition, can be applied to bankruptcy and winding-up, not all the rules in a petition in bankruptcy are applicable to a petition to wind-up a company by the court.

Section 265 Preferential payments

20.8 The section accords preferential status to a number of different classes of creditors in the distribution of dividends. The section sets out a list of creditors who benefit before other creditors are paid. In a usual case, the largest body of preferential creditors are the employees of insolvent companies who tend to take the largest number and amount of dividends. Employees may be compensated for loss of entitlements from the Protection of Wages on Insolvency Fund before a dividend is paid in a liquidation, in which case the Fund can claim an employee's dividend by way of subrogation. The Government is also accorded a deferred preference and there are other preferences, including specialised preferences that relate only to the insolvency of insurance companies and banks.

20.9 The *Consultation Paper* proposals on preferential payments under this section, while not universally criticised, were not well received in a number of strong submissions. Nonetheless, we stand by these proposals for the most part. We consider that the proposals were misunderstood by some of those making submissions, particularly with regard to the proposals relating to employees' preferences. Of all the issues addressed in this report, the question of preference, and we stress employees' preferences, is the most contentious.

Principle of pari passu distribution to be restated
Exceptions to principle only where considerations of maintenance of public order and the prevention of systemic failure are involved

20.10 The founding recommendation is that the principle of *pari passu* distribution needs to be re-established as the fundamental point of distribution in a winding-up. We have therefore recommended that the provisions of section 250 should be given due prominence, which would be achieved by moving the section to form a new sub-section (1) of section 265.[270]

20.11 While we accept that strict application of the principle of *pari passu* distribution must be tempered by certain considerations that outweigh the principle, those considerations should be clearly stated. In our view, there are only two grounds that carry sufficient weight to justify exclusion from the principle of *pari passu* distribution: (i) the maintenance of public order and (ii) the prevention of systemic failure in the areas of banking and insurance. We **recommend** that before an

[270] See paragraph 19.2.

exemption to the principle of *pari passu* distribution is accepted, it should be subject to the test of whether the exclusion is necessary to prevent systemic failure or to maintain public order. We have applied these tests to the individual recommendations on the current preferences.

20.12 This recommendation is consistent with the provisions of section 250 of the Ordinance, which, insofar as it relates to the rights of creditors, provides that, subject to the preferential payments provisions under section 265, the property of a liquidated company shall be applied *pari passu* in satisfaction of its liabilities. The interlopers in these two provisions are the more recent preferences that have arisen under section 265.

20.13 The proliferation of preferences under section 265 has occurred in piecemeal fashion over the last number of years. While no doubt carefully considered in each case we suggest that no effort had been made at any stage to take an overview of the entire provision. This is the purpose of these recommendations, that is, to look at the way all these preferences have affected the principle of *pari passu* distribution and to question whether all these preferences are desirable and whether it is correct to give a preference to one person by denying another person.

20.14 Some of the preferences have universal application to all liquidations, such as the preferential entitlements of employees, while other preferences are limited to particular types of business, such as the preference accorded to bank depositors.

Employees / The Protection of Wages on Insolvency Fund Board

20.15 As we have stated, the greatest criticisms of the recommendations under section 265 were on the recommendations on employees' preferences. We received strong reaction from some submissions. Much of the comment made was not on the proposals but consisted of a defence of the application of the Protection of Wages on Insolvency Ordinance. The application of the Protection of Wages on Insolvency Ordinance is outside our terms of reference and we cannot therefore comment on much of what was said in a number of lengthy submissions received. We prefer to limit our comment to what we consider are logical and reasonable recommendations that would serve the interests of the winding-up of companies well and which, we emphasise, would not and should not result in employees losing out on any statutory entitlements to which they are now entitled. If anything, the adoption of these recommendations and related recommendations would assist in simplifying the winding-up provisions and the establishment of the rights of employees to statutory entitlements.[271]

Recommendations on employees

20.16 The *Consultation Paper*'s proposal, which we now **recommend**, was that: "*preferential payments for employees in terms of the Companies Ordinance should be abolished*". The *Consultation Paper* also made it clear that employees should continue to receive compensation when their employer was liquidated.

20.17 We have stated that the primary legislation for the protection of employees' interests does not come under the winding-up provisions of the Companies Ordinance, it comes under the Protection of Wages on Insolvency Ordinance. The Protection of Wages on Insolvency Ordinance established the

[271] See, for instance, comment under paragraph 19.27.

Protection of Wages on Insolvency Fund Board which manages a Fund that pays employees compensation for losses incurred under the categories in the table below up to set monetary limits. Employees may claim in a liquidation as ordinary creditors for any amounts over the allowances that remain unpaid.

20.18 At present, there is a difference between the maximum amounts of entitlements under the Protection of Wages on Insolvency Ordinance and the maximums under the Companies Ordinance as set out below. The effect of the recommendations would be that these differences would fall away as the Companies Ordinance entitlements would be removed and only the Protection of Wages on Insolvency Ordinance would provide for employees' entitlements.

Type of Payment	Maximum amount under Protection of Wages on Insolvency Ordinance	Preferential limits under Companies Ordinance [272]
Arrears of Wages	$36,000	$8,000
Wages in lieu of notice	$22,500	$2,000
Severance payment	$50,000 + 50 per cent of excess entitlements [273]	$8,000

20.19 The only impact that this recommendation would have on employees would be in relation to the comment we make below on problems that appear to exist in the Labour Department on the admission of employees' claims. As a consequence of this recommendation, employees would only need to make a claim in a liquidation for amounts exceeding the Protection of Wages on Insolvency Ordinance limits.

Increase in the statutory entitlements under the Protection of Wages on Insolvency Ordinance

20.20 In this context, we note recent comment to the media that the Labour Department found that many people who were being made redundant during the current downturn were middle aged and middle ranking employees whose entitlements exceeded the statutory limits. We understand that the increase in the amount of severance payments from $36,000 to $50,000 in February 1999 is to provide more protection for such people.

20.21 The result of the recommendation on employees' preferences would be that employees would not lose any statutory entitlements to which they are currently entitled. We believe that this should satisfy the concerns of many of the submissions made.

Admission of employees' claims

20.22 We make this statement with one proviso. A submission from the Hong Kong Federation of Trade Unions stated that, as a consequence of the recent economic downturn, the Protection of Wages on Insolvency Fund had seen a marked

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[272] See also section 38 of the Bankruptcy Ordinance.

[273] The severance payment was increased to $50,000 from $36,000 with effect from 5 February 1999. See L.N. 34 of 1999.

increase in applications for payments from the Fund. The submission stated that, recently, the criteria for approving advance payment had also been stricter than before and many applications from employees had been rejected. The submission concluded that should employees' status as preferential creditors under the Companies Ordinance be abolished, employees might lose all chance of compensation. This written submission was supported by an oral submission received from another large trade union group.

20.23 We have no reason to doubt this submission. What the submission implies is that there are cases where employees, whose claims are rejected by the Labour Department which scrutinises claims on the Fund, can still get the preferential payments under the Companies Ordinance. This can only happen where the liquidator is satisfied that a person claiming to be an employee is in fact an employee but where the Labour Department has rejected the claim.

20.24 The Protection of Wages on Insolvency Fund Board in paragraph four of its submission which is set out in full below, referred to employees who fell outside the protection of the Fund having to rely on their preferential rights under the Companies Ordinance. This statement tends to support the contention of the Union bodies.

20.25 We ask who is right in these cases. If the Labour Department rejects the claim of an employee, why then do liquidators tend to accept them, as appears to be tacitly acknowledged by the Fund Board. Our view is that if an employee is entitled to a preferential payment he should be equally entitled to that claim under the Protection of Wages on Insolvency Ordinance and the Companies Ordinance.

20.26 We have not been provided with figures by the Union bodies as to how often this happens but we have been given to understand that these cases are not isolated ones. Again, this problem, which we consider to be a serious issue, is outside our terms of reference. If the Union bodies are satisfied that substantial injustice is being done to employees with legitimate claims on the Fund, the matter should be raised with those who scrutinise the claims. The problem lies there, not with these recommendations. The Labour Department might review its claim procedures in this regard.

That the Protection of Wages on Insolvency Fund should lose its subrogation preference

20.27 The *Consultation Paper* also proposed, and we now **recommend**, that the right of subrogation preference in respect of payments made by the Protection of Wages on Insolvency Fund Board should be abolished. The right of subrogation preference of the Board allows it to claim as a preferential creditor for all the amounts that it has paid to employees in a liquidation.

20.28 We maintain that no good and sufficient reason has been presented to us to justify retaining the preference. We received a number of submissions which opposed the abolition of the preference.

20.29 The *Consultation Paper* pointed out that in the six year period covering the Protection of Wages on Insolvency Fund Board's *Annual Reports* from 1991/92 to 1996/97, the Fund had made payments to employees of $556 million and had only recovered $49 million through subrogation. In that same period the Fund had an income of $1,233 million as against an expenditure of $599 million.

20.30 In the last reporting year, to 31 March 1998, the Fund recovered $14 million through subrogated preferences against total income of $261 million. It is clear that subrogation does not form a significant amount of the overall income of the Fund.

20.31 When this recommendation is considered clearly, all that is being recommended is that the Fund would lose its preferential rights of subrogation. The Fund would still, therefore, be able to subrogate as an ordinary creditor. The *Consultation Paper* estimated that the Fund would still be able to subrogate for about two-thirds of the amount as ordinary creditors.

20.32 We set out in full the Protection of Wages on Insolvency Fund Board's response to the *Consultation Paper* proposal on preferential payments, which we have numbered for convenience of reply:[274]

> "1. *We note that the Sub-committee [Consultation Paper] has made, among others, two proposals concerning preferential payments (Chapter 15) and the funding of the Official Receiver's Office (ORO) by a fixed proportion of the business registration certificate levy (Chapter 29), all of which will greatly affect the administration of the Protection of Wages on Insolvency Fund (the Fund). We would like to state our strong objection to these two proposals and present our arguments in the following paragraphs…*
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> 2. *In general, we maintain that preferential payment for employees should not be abolished. We consider that there are basic differences between wages and other benefits owed to an employee and debts owed to other creditors by an employer. In the event of insolvency of a company, affected employees lose not only their jobs - their only source of income - but also wages for work which they have performed. Hence, they are placed in a less advantageous position when compared with other ordinary creditors, who should be able to cope with the situation better as they usually have other sources of income to rely on.*
>
> 3. *We would strongly refute any suggestion that the Fund has given sufficient protection to the workers as there are limitations in making payments from it under existing legislation. Besides, it has always been functioning as some sort of insurance for workers to protect their income from wages paid by their employers rather than a welfare arrangement. In some winding-up cases, those workers who fall outside the protection*

[274] Note that the objection to the funding of the Official Receiver's Office through the Protection of Wages on Insolvency Fund's portion of the business registration fee has been addressed in Chapter 5, paragraph 5.6.

of the Fund would have to rely on their preferential rights for relief of financial hardship. In this respect, we consider that the Sub-committee may have misunderstood the operation of the scheme and under-estimated the sentiment of our workforce as well as the full impact of its recommendation in removing employees' preferences, particularly at a time when our economy is experiencing a prolonged period of slowdown.

4. We do not agree that the Sub-committee's proposal on pari passu distribution is in reality fair to the general body of creditors and the employees. Problems still remain in that under the Companies Ordinance, the holders of a floating charge will receive the proceeds of selling their security after the preferred creditors have been paid in the event of a winding-up and the company being insolvent (sections 79 and 265(3B)). So, even after the abolition of employees' preferences, the ordinary creditors still could not have a 'real' equal share of assets distribution so long as the holders of a floating charge are accorded a higher priority of payments over other creditors.

5. On the financial aspect of the proposal, we do not agree with the suggestion that if the Fund was an ordinary creditor, it would not lose a significant amount income overall in terms of its own income. Our recent experience suggests that the abolition of employees' preferences could result in a very substantial loss of subrogation income for the Fund. In the Yaohan Department Store case, for example, the preferential payments of employees amounted to $32 million, or 47% of the total amount of ex-gratia payments of $68 million paid out by the Fund. According to the liquidator, there is a high chance of the Fund being able to recover all of the preferential payments through subrogation. Thus, if the Fund was just an ordinary creditor, it would probably recover only a very small amount of payouts through subrogation in view that the total creditors' claims amounted to about $1.1 billion.

6. We note that the Sub-committee, based on a study of 20 insolvency cases by the ORO, made an estimate of the Fund's subrogation income and concluded that it could still receive about two-thirds of that amount through subrogation. We doubt very much its reliability and accuracy as the sample size of the ORO study is very small and that some of the cases date back to quite some years ago when the Fund's payment limits were much lower."

20.33 As regards paragraphs two and three of the Fund Board' s submission, employees whose claims are accepted by the Fund would be at no loss as a consequence of the recommendations. We accept that, ideally, employees can only be considered to have been entirely protected when every employee in every liquidation recovers all that is due to them.

20.34 Paragraph four of the Fund Board' s submission refers to the rights of secured creditors. The Fund Board is correct and we are well aware that the security obtained by creditors does not accord with the principle of *pari passu* distribution. We

have already addressed the position of secured creditors in the *Report on Corporate Rescue and Insolvent Trading* where we stated that "*there is no avoiding the rights of secured creditors and their importance in the world of business*".[275]

20.35 The law and practice relating to rights to security extends far beyond the winding-up provisions of the Companies Ordinance and, if the question of rights of security is to be addressed, it should not be addressed by this reference as it is a matter that reaches far beyond the question of winding-up. In any event, the point made by the Fund Board tends to be self-defeating as, if the preference enjoyed by secured creditors is considered to be a problem by the Fund Board, how is it that the right of subrogation preference enjoyed by the Fund is not, itself, a problem.

20.36 We accept that the study referred to in paragraph five of the Fund Board's submission is not scientific but it does indicate that the Fund would not lose all its rights to subrogation, only its preference, and that the effect on the value of the Fund would not be dramatic. The Fund Board did not produce definitive figures of its own but instead referred to one case, and that an exceptional case, the liquidation of the *Yaohan Department Store*, and stated that there was a high chance of the Fund being able to recover all of the payments made by subrogation. The *Yaohan Department Store* case is neither here nor there in the history of the Fund. The point to be taken is that, historically, the amounts that the Fund takes from preferential subrogation is not significant and the loss of the preference cannot constitute a risk to public order or a systemic risk.

20.37 Neither the Fund Board's nor any of the other submissions on the matter of the Fund's subrogation rights has given one good reason why the Fund should have a preference that allows it to take money that would otherwise go into the pocket of ordinary creditors. That is the crux of the issue. It is also worthy to note that the Fund's right of subrogation as a preferential creditor has the effect of denying employees who claim for excess entitlements as ordinary creditors. This point simply serves to highlight the inconsistency and basic unfairness of preferential entitlements.

20.38 We note the point made in recent *Annual Reports* of the Fund Board and some submissions that it is important to maintain the financial viability of the Fund. The assets of the Fund are being put to a severe test during the current downturn. The Fund Board reported in its *Annual Report* for 1996/97 that it had assets of $905 million at 31 March 1997. As at 30 October 1998, the Fund Board advised that the Fund stood at $809 million. We consider that it is too early in terms of this downturn to establish whether the Fund has adequate assets. Essentially, in any event, the question is one that is now irrelevant for the purposes of this report as there is no recommendation in the report which would affect the viability of the Fund.

Employees Compensation Assistance Fund

20.39 We received a submission from the Employees Compensation Assistance Board ("ECA") Fund Board on the question of the preference given to employees in respect of a claim under the ECA Ordinance (Cap. 365) and the ECA Fund under section 265(1)(cb) and (ce). The ECA Fund Board was established on 1 July 1991 under the ECA Ordinance to administer the ECA Fund for the protection of the entitlement of employees or dependants of a deceased employee to compensation and damages for work injury and for the protection of employers

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[275] See Chapter 13 of the *Report on Corporate Rescue and Insolvent Trading* generally, particularly paragraph 13.5.

against default of their insurers in respect of the employers' liability for such compensation and damages under the policies of insurance.

20.40 Section 265(1)(cb) of the Companies Ordinance provides that any amounts due in respect of compensation or liability for compensation under the Employees' Compensation Ordinance (Cap. 282) accrued before the winding-up should be regarded as preferential payments, except when the company has entered into a contract with a person carrying on accident insurance business in Hong Kong in respect of its liability under the Employees' Compensation Ordinance.

20.41 Section 265(1)(ce) also provides that any payment from the ECA Fund under Part IV of the ECA Ordinance representing an amount due by the company in respect of compensation or liability for compensation under the Employees' Compensation Ordinance accrued before the winding-up should also be regarded as preferential payments. The ECA Fund Board submitted that:

> "*It is a matter of principle that the injured employees' entitlement to compensation under the ECA Ordinance should have a preferential right over other civil debts. When a company is wound-up, employees who are injured by accidents arising out of and in the course of employment lose their jobs as well as compensation to which they are entitled due to work accidents. They are also placed in a more vulnerable position when compared with other ordinary creditors as they suffer from loss of earning capacity whereas other ordinary creditors would more likely be able to cope with the situation better as they usually have other resources to rely on. It is worth noting that, unlike other civil debts, non-payment of compensation is also a criminal offence under the ECA Ordinance.*
>
> *At present, if injured employees could not obtain compensation from their employers who are insolvent and there is no employee compensation insurance policy to cover them, they could apply for their compensation entitlements from the ECA Fund. In receiving assistance from the ECA Fund, the injured employee would have his rights, to the extent of the amount of the payment, transferred to and vested in the ECA Fund Board. The ECA Fund should have the same preferential status as an injured employee.*
>
> *According to the table below, the ECA Fund Board was able to recover about $1.2 million in 12 cases from the insolvent employers between 1995/96 and end of July 1998. The amount could be up to half a million dollars in individual cases. The payments recovered, albeit of moderate amount, have made up an increasing proportion of the total income of the ECA Fund. The table also shows the percentage share of recovered amounts as compared with the levy income for the year.*
>
> *Furthermore, recovery of payments is of particular importance to the ECA Fund in the light of the depleting resources of the ECA Fund. The abolishment of the preferential right of the ECA Fund under the Companies Ordinance will definitely have a significant adverse impact on the financial position of the ECA Fund.*"

Employees Compensation Assistance Fund Board

Year	*Dividend (Refund) ($)*	*Total Levy Income ($)*	*Share of dividend (refund) expressed as a percentage of total levy income*
95-96	*21,283.41*	*31.7 million*	*0.07%*
96-97	*120,230.12*	*23.9 million*	*0.50%*
97-98	*1,035,700.75*	*28.5 million*	*3.60%*

20.42 The ECA Fund Board raised two issues, the preferential entitlements of injured employees with claims against a company under the ECA Ordinance and the preferential entitlement of the ECA Fund.

20.43 We have every sympathy for and support the principle of employees' compensation under the ECA Ordinance but we can see no reason why ordinary creditors should be expected to effectively subsidise the Fund. If the Fund is losing money, as was the case in 1996/97, the appropriate means of maintaining the Fund's assets would be through an increase in the levy. We **recommend** that the preferential rights of the ECA Fund accorded under section 265 should be abolished.

20.44 The ECA Fund is financed by a levy on employees' compensation insurance. The levy is 3.5% of all employee compensation insurance premiums payable by employers. The ECA Fund's *Annual Report* for 1996/97 reported that in the financial year 1996/97 the ECA Fund recorded a deficit of $11.5 million, reducing the ECA Fund reserve for assisting eligible applications to $55.3 million. We can, however, see no justification for using money that should be paid to ordinary creditors to finance the ECA Fund. In the period 1991 to 1997 payments totalling $84 million were made by the Fund.

20.45 We note that subrogation only amounted to 3.6% of the ECA Fund's total income for 1997/98. The ECA Fund Board's submission stated that the abolition of the preferential right would have a significant adverse impact on the financial position of the ECA Fund. We would respectfully suggest that that part of the submission is exaggerated as 3.6% is not a significant percentage and the recommendation is only for the loss of preferential right. The ECA Fund would still retain its rights as an ordinary creditor.

Insurance

20.46 The Commissioner of Insurance has explained that the Companies (Amendment) (No. 3) Ordinance 1988 accorded preferential status to persons with insurance claims under a contract of general insurance business. The preferential status was given to persons with insurance claims in order to protect and retain the Hong Kong assets for them, particularly in the case of a branch office of an overseas insurance company. It was considered that, under the then Companies (Winding-up) Rules, Hong Kong insurance claimants were very exposed in the liquidation of an overseas insurance company having a branch operation in Hong Kong.

20.47 This was because there was no requirement in the winding-up rules that all the liabilities of an insurance company's local branch had to be met before assets were withdrawn from Hong Kong. The provisions enabling the Hong Kong

court to wind-up overseas companies with assets in Hong Kong might not therefore provide a sufficient safeguard to meet domestic liabilities. The Hong Kong insurance claimants would receive very little or nothing in the liquidation of an overseas insurance company because the assets withdrawn from Hong Kong would be used to pay off in priority all preferential creditors in its country of incorporation, including insurance claimants in that place. There was therefore a need to protect local insurance claimants.

20.48 To strengthen the protection to local insurance claimants, an amendment was made to the Insurance Companies Ordinance (Cap. 41) in 1994 to require all insurance companies carrying on general insurance business to maintain assets in Hong Kong to match these local liabilities. The objective was to ensure that, in the event of liquidation of an insurance company, the assets retained in Hong Kong would be sufficient to meet the claims of the Hong Kong insurance claimants. The objective would be entirely defeated if the preferential status of local insurance claimants were to be removed.

20.49 The Commissioner of Insurance maintained that:

> *"Insurance is very important to every walk of life. A contract of insurance is not an ordinary contract for the supply of goods but rather a contract for financial protection against some future mishaps. Insurance is bought by both individuals and business enterprises to cover those financial losses which they cannot afford to suffer.*
>
> *Insurance also offers a very strong support to the development of new business ventures as their owners know they are fully protected against any risks associated with them. It plays a very important role in ensuring that any innocent third parties injured or affected in an accident would be properly indemnified, for example, under the different classes of compulsory insurance business in Hong Kong including motor and employees compensation. The protection to employees offered by the Employees Compensation Assistance Ordinance is also built on the preferential status of insurance claimants. it would be disastrous and extremely socially undesirable not to maintain their preferential status.*
>
> *Insurance is a regulated business and the need for better protection to insurance claimants is recognised in most major overseas countries, such as Singapore, Malaysia, Japan, and the United Kingdom, where they are invariably accorded a preferential status or other similar protection. It is therefore our strong view that the preferential status of insurance claimants should be maintained."*

20.50 We understand that part of the impetus behind the introduction of the insurance preference resulted from a series of liquidations of insurance companies in the mid-1980s.[276] We accept that the insolvency of insurance companies poses special difficulties and that our tests of maintenance of public order or prevention of

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[276] The Official Receiver advised that there were 10 insurance companies wound-up between 1980 and 1990, including *Singapore Insurance Co Ltd.* in 1980, *Scotland Insurance Co Ltd.* and *China Underwriters Life and General Insurance Co Ltd.* in 1983, *Bedford Insurance Co Ltd*. in 1984 and *Armour Insurance Co Ltd.* in 1990. More recently there was the liquidation of *Kansa General International Co Ltd.* in 1995.

systemic failure dictate that the insurance companies' preference should be maintained. We therefore **recommend** that the insurance preference should be retained. We note that retention of the preference would have no impact on the vast majority of windings-up.

Bank depositors

20.51 Certain bank deposits are now afforded preferential status under sub-sections (1)(db), (5D) and (5E) which were introduced in 1995.[277] These provisions give a preference to amounts held on deposit with an insolvent bank up to a maximum aggregate of $100,000 for each depositor, no matter how many accounts a depositor has with the bank. We understand that the $100,000 amount is an amount that would remove about 95 per cent of creditors from any banking liquidation. Unlike most other companies that are wound-up, amounts owed to bank depositors are simple to ascertain through bank records and in the vast majority of deposits there is no dispute as to the amount.

20.52 Prior to the publication of the Consultation Paper, the Hong Kong Monetary Authority submitted that:

> *"..the scheme for priority claims for small depositors, which is now provided under section 265(1)(db) of the Companies Ordinance, should remain in the winding-up provisions. You may also wish to note that we are now considering the issue of a guideline to banks to ensure the they have sufficient assets in Hong Kong to fulfil the requirement for priority payment to small depositors under section 256(1)(db). We may also require banks to maintain sufficient liquefiable assets in Hong Kong so that they will be able to make interim urgent payments to depositors for emergency needs as in the case of BCC (HK) Ltd."*

20.53 The Hong Kong Monetary Authority stated that the banks provided the principal means by which corporate and individuals' surplus resources provided the liquidity necessary in the economy. The collapse of a bank can adversely affect not only individual depositors but also the economy as a whole and, for these reasons, a comprehensive scheme of supervision exists within Hong Kong and other leading financial centres.

20.54 Most individuals and companies choose to open a deposit account with a bank. Many individuals place a significant part of their surplus funds, if not all of them, with one or perhaps two banks. The consequence to them of a collapse of that bank or those banks and their inability to repay those deposits is therefore potentially disastrous. The knock-on effect on their creditors might lead to waves of bankruptcies which could have serious implications for the banking system and the economy.

20.55 Individuals respond differently to this type of loss. At worst, there are public order implications. Most developed banking centres have schemes providing limited protection for depositors in public deposit-taking institutions. For example, the depositor protection scheme in the United Kingdom takes the form of a fund contributed to by banks which can be used to make good the losses of small depositors. The introduction of such a scheme in Hong Kong has been discussed with the banks. However, there was no widespread support for such a scheme. The priority scheme was then introduced as an alternative. Similar arrangements exist in countries such as Switzerland and Australia (the recent Wallis inquiry into the

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277 Companies (Amendment) Ordinance 1995, section 16.

Australian financial system not only supported the statutory preference for depositors in banks, but suggested that it be extended to building societies and credit unions).

20.56 The Monetary Authority appreciated that the banks' general unsecured trade creditors were arguably the ones to suffer as a result of these priorities but there were two points to be made on this. First, they usually have a choice as to whether or not they enter into a commercial transaction from which they expect to receive a commercial profit. The depositor has to use the banking system. Second, the contraction of the economy attendant on the collapse of a bank may well have repercussions for those commercial creditors that go beyond the immediate reduction in their ability to recover from the stricken bank's liquidation. It is arguably in their interests that large numbers of depositors are not reduced to bankruptcy overnight. The advantages to them and the public of the maintenance of public order are obvious.

20.57 We accept that the banking system is an area where there are implications for the economy as a whole which go beyond narrow insolvency considerations and that the tests of the prevention of systemic failure and the maintenance of public order apply to the banking sector as to no other commercial activity in Hong Kong.

20.58 We received no submissions opposing the provision but we note that one submission suggested that the $100,000 figure should be reviewed periodically, perhaps every five years, on the basis of the average or median balances held at banks. We therefore **recommend** that the banking preference should be retained and note that, as with insurance, the preference would apply in a very small number of cases.

The Government

20.59 Under sub-section (1)(d), the Government has a preference for all statutory debts due from a company within 12 months before the company is wound-up.

20.60 The *Consultation Paper* proposed that the Government's preference for all debts due to it, no matter how they arose, should be abolished. The *Consultation Paper* noted that the Government could still claim as an ordinary creditor.

20.61 Prior to the publication of the *Consultation Paper*, the Commissioner of Inland Revenue laid out reasons justifying the Government's preferential status. The Commissioner stated that he supported the principle of *pari passu* distribution of assets of insolvent companies and persons to creditors, unless there were compelling reasons to do otherwise. The Commissioner considered that certain debts owed to the Government were compelling enough to attract a preference:

> "*Debts due to the Government can be divided into two categories, the first being ordinary debts due to the Government as an ordinary creditor, and the other being taxes and duties due to the Government by an insolvent as a tax payer or duty payer. A debt under the first category may arise from the supply of goods or services by the Government, for example, an unpaid water charges bill. In such cases, the Government is in no different position from any other creditors of the insolvent and therefore should be treated pari passu in the distribution of assets.*

The case of taxes and duties is quite different. A tax or duty represents a civic obligation owed to the country. It has its social or fiscal objectives to play in terms of re-distribution of income and wealth, etc. The public interest requires that what is due to the Government by way of taxes and duties are fully paid. That is precisely why taxes and duties are always treated differently from ordinary debts and the Government is given wide powers of recovery, including the issue of departure prevention directions, in the tax statutes. The successful recovery of taxes by the Government is not just for the benefit of its coffer, but for the benefit of the public at large. As a matter of fact, the collections of the Inland Revenue Department contribute very significantly to the general revenue of the Government each year; more than 60 per cent. Any irrecoverable defaults by a certain group of taxpayers will inevitably and inequitably fall on other fellow taxpayers.

On the philosophical side, a tax debt needs to be protected in the case of insolvency. Unlike an ordinary creditor in business with a company, the Inland Revenue Department usually has no dealings with the company throughout the year and hence does not know or become aware of its financial position. Also, the Inland Revenue Department cannot take steps to secure the tax debts by means of mortgages, charges, etc. which other creditors may be able to arrange. By the time the company returns its trading results to the Inland Revenue Department, it would be at least several months after the close of its accounts and therefore even if the Inland Revenue Department knew that the company was insolvent, it could do practically nothing to protect the revenue by then. Section 265(1)(d) which accords, and indeed restricts, priority to, among other things, tax debts that are due within 12 months next before the relevant date, is fair and reasonable in the circumstances.

When other tax administrations around the world are looked at, it can be confirmed that Hong Kong is not unique in granting preferential entitlement to tax debts in insolvency cases. Under sections 726 and 507(8) of the United States Bankruptcy Code, taxes of various kinds are ranked preferential just after the claims for employee benefits such as wages and salaries. Similarly, the Insolvency Act 1986 gives preferential treatment to taxes such as 'Pay As You Earn', Value Added Tax, employment regulation payments, etc. Other examples are found in the legislation of Canada, Australia and China.

If it is considered that the words 'all statutory debts' appearing in section 265(1)(d) are too wide, the Department would have no objection to having this section suitably amended so long as it covers at least the taxes and duties chargeable under the various tax Ordinances."

20.62 The *Consultation Paper* noted that the *Cork Report* was strongly opposed to Government debts having a priority.[278] It appeared that many of the *Cork Report*'s specific recommendations for the reduction of the number of Crown

[278] *The Cork Report*, paragraphs 1410 to 1426.

preferences was initially accepted but that since the introduction of the Insolvency Act 1986 there has been a proliferation of new Crown preferences. The comments set out below are extracted from the *Cork Report*:

> *"We unhesitatingly reject the argument that debts owed to the community ought to be paid in priority to debts owed to private creditors. A bad debt owed to the State is likely to be insignificant in terms of total Government receipts; the loss of a similar sum by a private creditor may cause substantial hardship, and bring further insolvencies in its train.*
>
> *It is the fact that the Government is an involuntary creditor in respect of unpaid tax. Unlike other creditors, the Revenue cannot choose those with whom it will transact business. The Government is not alone in being an involuntary creditor. Many suppliers of goods and services are constrained to extend credit facilities in accordance with the custom of the trade.*
>
> *In our view, the ancient prerogative of the Government to priority for unpaid tax cannot be supported by principle or expediency, and cannot stand against the powerful tide calling for fairness and reform.*
>
> *In certain special cases, however, such as PAYE, National Insurance contributions, value added tax and car tax, different considerations obtain. In these cases, the Government's claim is for moneys collected by the debtor, whether by deduction or charge, and for which the debtor is accountable to the Government; the debtor is to be regarded as a tax collector rather than a taxpayer. We cannot think it right that statutory provisions enacted for the more convenient collection of the revenue should ensure to be benefit of private creditors.*
>
> *The arguments against the retention of any general preference for unpaid tax apply with even greater force to general rates. Rates are payable in advance at intervals of six months, though there is provision for domestic rates in arrear by monthly instalments. There is therefore no reason for large arrears to accumulate. Moreover, rating authorities have statutory rights of distress and other summary remedies available to them for the recovery of unpaid rates."*

20.63 The *Consultation Paper* agreed with the *Cork Report* to a great extent. The *Consultation Paper* noted, however, the distinction made in both the *Cork Report* and the submission of the Commissioner of Inland Revenue in relation to debts due to the Government which might be classed as ordinary debts due to the Government and those debts which arose in respect of taxes and duties. The *Consultation Paper* noted that the Government did not make as extensive use of companies as tax collectors as was the case in other jurisdictions in respect of, for example, deduction from salaries of tax due from employees (PAYE), but that the question did arise in certain cases. Obvious examples are departure taxes collected by airlines on behalf of the Government and the duty collected for Government by road toll operators.

20.64 The *Consultation Paper* considered, however, that a preference accorded to the Government in respect of the collection of such taxes was not justifiable under the public order and systemic failure criteria as the Government is not forced to use companies to collect taxes. The *Consultation Paper* stated that the Government presumably found it convenient and efficient to collect taxes in this way and it was therefore reasonable for the Government to assume a certain level of risk

in such operations, similar in many ways, to the sort of risk assumed by suppliers and other habitual ordinary creditors who supplied goods and services to companies.

20.65 The *Consultation Paper* could not see, nor can we see, any justification for the Government having a preference over, say, a small business which had also been unable to collect on its debt. In our view, by taking a preference over the small business, the Government is taking money out of the pocket of the ordinary creditor. There is no element of fairness involved in this preference, it is simply a matter that the Government knows that it will be a creditor in a certain number of cases at any given time and it has moved to protect its position.

20.66 The *Consultation Paper* had no doubt that the amounts recovered by the Government as a preferential creditor had barely any impact on overall Government revenues. The significant figure is the difference between the amount the Government recovers in all liquidations as a preferential creditor, less the amount it would have received as an ordinary creditor.

20.67 The Commissioner of Inland Revenue took issue with the Consultation Paper on this point. The Commissioner stated that a tax debt needed to be protected and added that:

> "*In a recent study on 20 sample compulsory winding-up cases, we found without surprise that the tax recovery potential of the preferential claims is more than 10 times over that of the ordinary claims. While more than 13% of the preferential tax debts (in 11 of the cases) were successfully recovered, only 0.9% of the ordinary tax debts (in 9 of the cases) were eventually collected. From our perspective, the findings of this study give strong support to the view that the preferential status for tax debts should be retained.*"

20.68 This Commissioner of Inland Revenue's submission lends credence to the idea that preferential payments are effective in increasing the amounts that are recoverable by preferential creditors but our own unscientific attempts to calculate the benefit provided by preferences were frustrated by consideration about the type of sample taken.

20.69 In looking for an average in all cases it is necessary to consider which forms of winding-up are used in the calculation. For instance, in a members' (solvent) voluntary winding-up all creditors should be paid in full which would tend to distort the impact on the effect on creditors in creditors' (insolvent) voluntary winding-up and winding-up by the court. There is also no easy availability of information on creditors' (insolvent) voluntary winding-up.

20.70 If, then, a calculation is to be made on windings-up by the court only, it would be necessary to consider whether to include cases, and they are many, where no preferential or ordinary dividend is paid. In addition, every case involves different numbers of creditors owed different amounts. How can these variables be averaged against different amounts of debt owed? It is for this reason that we have avoided placing too much emphasis on amounts that might or might not be involved and prefer to address the issue of preferences in principle.

20.71 We maintain that there must be an overwhelming reason for a preference to exist. We do not consider that the Government has a good case for a preference for the reasons stated and **recommend** the abolition of the Government's preference. Furthermore, the Commissioner, as with every other party who argues for maintaining its own preference, seems impervious to the fact that the preference

he is defending has the effect, by his own admission based on the figures he produces, of taking money out of the pockets of ordinary creditors.

20.72 The Commissioner reiterated that:

> " ... *a clear distinction must be made between an ordinary debt and a tax or duty. A tax or duty, being a civic obligation owed to the country, has its role of redistribution of income and wealth. Tax is the basic source of government revenue for providing benefit to the public at large. The failure of the Government to recover taxes successfully will seriously jeopardise the public interest and will cast difficulties on the maintenance of public order. Unlike other types of private debts, the consequence will have to be borne by the entire community.*"

20.73 We do not accept the maintenance of public order argument. Hong Kong is accepted as a low insolvency jurisdiction and, as stated above, the amount that the Government collects from insolvent companies must be minuscule in terms of its overall revenue. The Government is, however, a frequent claimant in windings-up. The effect of the Government' s preference must therefore consistently reduce the amounts that ordinary creditors receive.

20.74 We would add that the unfortunate ordinary creditor never knows where misfortune will strike, must do business, must take risks in supplying goods on credit, and must know that in the event that the risk goes bad, every other creditor with a bit of influence will get paid first. In that sense, the ordinary creditor is in much the same position as pointed out by the Commissioner of Inland Revenue: he usually is not aware of a debtor company's financial position despite his dealings with the company. The difference between an ordinary creditor and the Government is that the ordinary creditor has already paid for the goods or services that constitute the debt; the Government cannot readily make that claim.

20.75 We note that we received three submissions supporting the abolition of the Government' s preference. Only the Commissioner of Inland Revenue supported retention of the preference.

Fines

20.76 Fines are also provable debts recoverable as a deferred debt by the Government under section 265(1)(d). The *Report on Bankruptcy* recommended that fines should not be provable in a bankruptcy and should not be released by a bankrupt' s discharge.[279] The intention behind the recommendation was that a bankrupt should not benefit from bankruptcy by only paying a proportion of any fines in the form of a dividend. The same situation does not apply to companies in liquidation, however, as they are unlikely to emerge from liquidation. If fines were not provable in liquidation, the result would be that the fines would be lost to the Government, which we see as being unfair. We therefore **recommend** that fines should be provable in winding-up but only as an ordinary debt.

Companies Registry

279 *Report on Bankruptcy*, paragraphs 20.29 to 20.40.

20.77 Under sub-section (1)(da), when a company is revived within 20 years of being struck off under section 290A(6), the fee payable under the section may be claimed by the Registrar of Companies as a preference.

20.78 This preference was introduced in 1993[280] to recover a particular fee payable to the Registrar of Companies for the revival of companies. The *Consultation Paper* stated that it had difficulty understanding why this preference was introduced as the only way that the debt could arise would be if the revival fee was paid for by a cheque which was subsequently dishonoured. The preference is unnecessary as the Registrar of Companies can simply wait for cheques to be cleared before he revives a company and, probably, in practice, it takes longer to complete the revival exercise than it does to clear a cheque.

20.79 In addition, a debt due to the Registrar of Companies can be claimed as a statutory debt due to the Government under sub-section (1)(d). By providing for the debt under sub-section (1)(da), it appears that the Registrar of Companies has secured a preference lower in priority than he would have had under sub-section (1)(d), by virtue of sub-section (3A). We **recommend** that the preference should be abolished for the same reasons that the preference for other Government debts should be abolished.

20.80 We note that the Registrar of Companies agreed that the preferential payment regarding the fee payable under section 290A(6) should also be abolished.[281]

Distraint / landlords

20.81 Sub-sections 265(5) and (5A) provide a preference for landlords and others who distrain on the goods or effects of a company. The effect is that where goods are distrained against within three months before the date of the winding-up order, sub-section (5) creates a charge over the proceeds of the distraint which must be used to pay all debts which are given a preference under section 265 before the proceeds can be used to pay the creditor who initiated the distraint. Under sub-section (5A), the distraining creditor who initiates the distraint then has a preference on any balance of the proceeds of the distraint remaining, in priority to all other creditors. The distraining creditor also has a claim in preference to all other non-preferential creditors for any amount that has been taken from the proceeds of the distraint to pay preferential creditors under section 265. This has the effect of placing the proceeds of a distraint made within three months of the winding-up order in "*quasi-preferential*" position.

20.82 Prior to the publication of the *Consultation Paper,* the Hong Kong Association of Banks submitted that:

> *"The position of a landlord distraining for rent should be re-considered. A landlord distraining for rent is not in a different position from a normal judgement creditor enforcing his judgment but in a liquidation he is as a matter of law given a higher priority than a judgement creditor."*

[280] Ordinance No. 10 of 1993, section 2.

[281] The Companies (Amendment) Bill 1999 proposes that the sub-section should be repealed.

20.83 The *Consultation Paper* agreed with the Association' s comments and proposed and we now **recommend** that the preference should be abolished. By that, we mean that any proceeds of a distraint made within three months of a winding-up should be considered to be part of the assets of the estate of the company if it has not been paid out to the distraining creditor by the date of the commencement of the winding-up, as opposed to the date of the winding-up order.

20.84 If the recommendations for the abolition of nearly all preferences are not followed, we **recommend** that the quasi-preference given under these sub-sections should be abolished with the effect that, if the proceeds of distraint become available to the estate of a company, no preference should be accorded to the distraining creditor for any amount applied to paying other preferential creditors, or in respect of any balance remaining. The distraining creditor should not have any form of preference for proceeds distrained against but available to the estate.

20.85 We received a submission that stated that a landlord was in a different position from a normal judgment creditor in that, in a sense, a landlord was in a weaker position than most other creditors. Having lent the use of his land in exchange for rent, he could not readily deny a debtor tenant further benefit from the loan. The submission argued that while a supplier of goods or lender of money could at least refuse to grant his debtor more credit, a landlord could prevent further use of his land only by re-entering, a risky business, or obtaining a possession order, a lengthy business.[282]

20.86 We accept that while a landlord might take some time to recover the use of his property this does not seem to have prevented companies and individuals investing in property. We are also of the view that landlords have long been able to look after their own interests by, for example, insisting on rental deposits, a protection that most ordinary creditors could only dream of.

20.87 If the abolition of this preference were to put pressure on landlords and rentals generally, which we doubt, the additional risk would be reflected in the rental charged or the amount of the deposit.

Priorities of debts

20.88 The Hong Kong Society of Accountants submitted that:

> *" Section 265 is now a very complicated and cumbersome section. We propose that this section be redrafted along some basic underlying principles, such as follows:*
>
> *(1) the priority of payment of costs, expenses and creditors' claims in a liquidation be dealt with in a linear order of priority of payments;*
>
> *(2) all references to amounts be excluded from this section and be placed in a separate schedule, to facilitate future revisions to these amounts by subsidiary legislation;*

282 This submission quoted an extract from *Hong Kong Tenancy Law*, 3rd edition, by Malcolm Merry, Barrister.

> (3) *the number of classes of priority creditors should be reduced for specified debts. This would better reflect the principle of pari passu than is presently the case;*
>
> (4) *debts within each class should 'rank equally among themselves' (pari passu principle);*
>
> (5) *debts within the class should be paid in full unless the assets are insufficient to meet them, in which case they should be abated in equal proportions among themselves; and*
>
> (6) *it would be beneficial to merely allow as the preferential amount an amount in total which is outstanding to employees. This amount may be made up of holiday pay, severance pay, wages etc. due as at the date of liquidation. This would further simplify calculation of priorities and ensure that set limits are also easy to understand and amend in the future."*

20.89 We simply note the submission for the purposes of the report as the recommendations would abolish most preferences. If the recommendations are not accepted, it would be worth considering the Society's submission as a means of making the preferential provisions understandable.

Discretionary preference under sub-section (5B) to remain [283]

20.90 This sub-section provides, among other things, that where in a winding-up, assets have been recovered under an indemnity for costs of litigation given by certain creditors, the court may, on the application of the Official Receiver or the liquidator or any such creditor, make such order as it deems just with respect to the distribution of the assets recovered, with a view to giving those creditors an advantage over others in consideration of the risk run by them in so doing.

20.91 We consider that this provision is important and should be retained. It falls outside the general preferences which are provided for as of right. We consider that any creditor who is prepared to risk money to recover money should be able to apply to the court for the court to exercise its discretion to give a preference in such circumstances.

Bankruptcy Ordinance

20.92 We **recommend** that these recommendations should also be applied to section 38 of the Bankruptcy Ordinance, which contains equivalent provisions.

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[283] Section 38(5B) is the equivalent section under the Bankruptcy Ordinance. Note also comment made in paragraphs 19.84 to 19.86 of the *Report on Corporate Rescue and Insolvent Trading*. Note, too, *in re Intertrans Far East Ltd.* [1994] 2 HKC 704.

Chapter 21 - Effect of Winding-up on Antecedent and Other Transactions

Section 266 Fraudulent preference
Section 266B Fraudulent preference deemed to be an unfair preference

21.1 Section 266 was recently amended by replacing the former provisions on fraudulent preference with provisions which relate to unfair preference. The Companies Ordinance provisions came into effect on 10 February 1997 as a consequence of the amendments made by the Companies (Amendment) Ordinance 1997 and the Bankruptcy (Amendment) Ordinance 1996.

21.2 The Bankruptcy (Amendment) Ordinance 1996, section 76, amended the Companies Ordinance by adding a new section 266B which provides that fraudulent preference under section 266 is deemed to be an unfair preference. The effect is that where a company is wound-up and it has, at the relevant time, given an unfair preference to any person, the liquidator may apply to the court for an order that the position should be restored to what it would have been if the company had not given the unfair preference.

21.3 The reference to "*fraudulent*", and therefore the implication that an improper motive must be shown, has been removed. Under the new provision, a liquidator does not even need to show that the dominant intention was to give one creditor a preference but only that the company was influenced by a desire to bring about a preference.

Disqualification of directors

21.4 The fifteenth schedule to the Companies Ordinance sets out matters for determining the unfitness of directors. A director may, under section 168H, be disqualified by the court, for between one and 15 years, from acting as a director if he has been responsible for a company, among other things, entering into any transaction or giving a preference, being a transaction or preference liable to be set aside under section 182 or section 266. The *Official Receiver's Office Annual Departmental Report 1996/97* reports that one director was disqualified for five years under this provision. The Report for 1997/98 indicates that there were no prosecutions under the section. The 1996/97 prosecution appears to have been the only disqualification for this kind of conduct under section 266 since section 168H was introduced in 1994.

Unfair preference to creditors, sureties or guarantors

21.5 A company gives an unfair preference if the person given the preference is one of the company's creditors or a surety or a guarantor for any of the debts or other liabilities of the company, and the company does something which has the effect of putting that person into a position which, in the event of the company being wound-up, is better than the position he would have been in if that thing had not

been done. The new provision under section 51A(1)(e) of the Bankruptcy Ordinance, gives the court power to re-impose obligations on a guarantor or surety if the original obligations had been released or discharged by a transaction which was subsequently overturned, and to reinstate a security with the same priority as a former security or charge.

Company influenced by a desire to give a preference

21.6 The court will only make an order under the section if the company giving the unfair preference was influenced in deciding to give it by a desire to put the person into a better position than he would have been in.[284]

Preference to an associate

21.7 If the person preferred is an associate of the company, otherwise than by reason of being an employee, the desire to put the person into a better position is presumed, unless the contrary is shown.[285]

Relevant time

21.8 The relevant time referred to above is two years before the date of the presentation of the petition to wind-up a company in respect of a person who is an associate of the company, and six months before presentation in respect of anyone else.[286]

Employees to be included in unfair preference provisions

21.9 We note that section 50(5) of the Bankruptcy Ordinance provides that unless the contrary is shown, a debtor who has given an unfair preference to another person who was an associate is presumed to have been influenced by a desire to put that person into a better position. An exception to the presumption is provided, however, for employees. The Insolvency Act, section 239(6), which provides for unfair preferences, also provides an exception to the presumption for employees.

21.10 We **recommend** that the exception in respect of employees should not apply in relation to companies in Hong Kong on the basis that many of these companies, large and small, are controlled by a small number of people, often of the same family, whereas in the United Kingdom companies tend to be controlled by more diversified interests. We consider that providing for employees to be excluded from the unfair preference provisions could provide a loophole that might be exploited by closely connected controlling interests.

Provisions to be set out in the Companies Ordinance

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284 See section 50(4) of the Bankruptcy Ordinance (section 36 of the Bankruptcy (Amendment) Ordinance 1996).

285 See section 50(5) of the Bankruptcy Ordinance.

286 See section 51 of the Bankruptcy Ordinance.

21.11 A number of submissions made prior to the publication of the *Consultation Paper* supported the idea of introducing effective provisions to facilitate the recovery of company property that has been misapplied.[287]

21.12 We support the intentions underlying the changes that have been made recently. The recommendations made below would complete the process started by the recent amendments. There is a need to strengthen the Companies Ordinance provisions to allow insolvency practitioners to recover assets which have been the subject of a preference by a company prior to liquidation. We **recommend** that these provisions should be set out in the Companies Ordinance rather than by reference to the Bankruptcy Ordinance provisions. In addition to the obvious advantage of ease of reference, it would mean that the provisions on "*Associate*", referred to below, would be tailored to fit the needs of the Companies Ordinance.

Connected persons

21.13 We **recommend** the adoption of section 249 of the Insolvency Act, which provides that a person is connected with a company if he is a director or shadow director of the company or an associate of such a director or shadow director, or he is an associate of the company.

21.14 In this context, we note the recommendation that the definitions of shadow directors found in sections 168C or section 351(2) should be applied to all the winding-up provisions.[288]

Associate

21.15 It has been commented on that a problem arises with the new definition of "*associate*" contained in the new section 51B of the Bankruptcy Ordinance. The new definition only includes as an associate an entity of which the debtor company has control. "*Associate*" therefore includes subsidiaries of a debtor company but it has been questioned whether a strict interpretation of the legislation would result in a parent company being classified as an associate because a debtor company which is a subsidiary does not have control over its parent and therefore would not be defined as an associate under section 51B.[289]

21.16 The comment continues that the inconsistency is as a result of the Companies Ordinance incorporating provisions which were drafted with a natural person in mind, who cannot, of course, have a parent entity and that, unless amendments are made, it would appear that unfair preferences given to a parent entity would only be recoverable if they were made within six months prior to the liquidation of the subsidiary.

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287 See paragraphs 16.10 to 16.15 of the *Consultation Paper*.

288 Note that there are similar provisions under section 49BA(9) of the Companies Ordinance, which defines director for the purposes of requirements for a listed company to buy its own shares, section 109(5) in relation to general provisions on annual returns, section 158(1) in relation to the register of directors and secretaries, and section 341 in relation to the interpretation of Part XI (Companies incorporated outside Hong Kong). Section 2(2) provides a saving in respect of advice given in a professional capacity.

289 See "*Extortion, undervalue and preferences - creditors beware*", David Kennedy, Nelson Wheeler Corporate Reconstruction and Insolvency Limited; article in the *Accounting Post*, March 1997.

21.17 The Official Receiver acknowledges that this is the case but that the intention was that the amendment to section 266 should be a temporary measure pending a comprehensive examination of the winding-up provisions by the Commission. The Official Receiver stated that any reference to "*connected persons*", as provided for under section 249 of the Insolvency Act, was carefully avoided since "*connected persons*" included "*shadow directors*" who were mentioned or defined only in sections 158 and 168C of the Companies Ordinance, and were not mentioned in the interpretation provisions under section 2.

21.18 The definition of "*associate*" is found under section 435 of the Insolvency Act. The Bankruptcy Ordinance , section 51B, adopted most of the definitions of associate but could not make provision for companies being associates of other companies. We therefore **recommend** that the definition of a company's association with another company, under section 435(6) of the Insolvency Act, should be adopted.

21.19 Under section 435(6) of the Insolvency Act, a company is an associate of another company:

> *"(1) if the same person has control of both, or a person had control of one and persons who are his associates, or he and persons who are his associates, have control of the other, or*
>
> *(2) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person of whom he is an associate."*

21.20 The effect of the two recommendations on connected persons and associates would not only bring the person or group of persons who had control of the company under the longer relevant time for associates, it would also bring in the associates of those persons who controlled the company. This would include any person with a close family connection to the person who controlled the company, including spouses, former spouses, siblings, aunts, uncles, nephews, nieces, and other lineal ancestors and descendants.

Transactions at an undervalue

21.21 The Bankruptcy (Amendment) Ordinance 1996, section 36,[290] also introduced provisions on transactions at an undervalue into the Bankruptcy Ordinance. These provisions were not applied to the winding-up provisions because the Government did not want to pre-empt the recommendations of the Commission.

21.22 The Official Receiver advised us that it was considered that proceedings could still be issued against directors of companies for assignments of property which defrauded creditors, under section 60 of the Conveyancing and Property Ordinance (Cap. 219).

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[290] This is the new section 49 in the Bankruptcy Ordinance. The Insolvency Act equivalent is section 238.

21.23 We **recommend** that it would be appropriate to introduce provisions on transactions at an undervalue into the Companies Ordinance. The effect of the provision would be that, where a company makes a gift to a person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration, or, the company enters into a transaction with that person for a consideration which is significantly less that the actual value of the subject of the transaction, the court may make an order to restore the position to what it would have been if the company had not entered into the transaction.

Provisons for transaction at an undervalue to include transaction at an overvalue

21.24 We received a submission that the provisions for transactions at an undervalue should include a situation where a company has purchased assets at inflated prices. We consider that the effect on a company would be the same and that the submission brings out another way of looking at the same situation. There is no difference in our minds between a company selling assets at an undervalue and purchasing at an overvalue, particularly when a connected person is involved. Accordingly, we **recommend** that the provisions on transactions at an undervalue should include transaction at an overvalue. This would require a change of name to the provision. It would also be appropriate to consider amending the Bankruptcy Ordinance provisions to take account of this recommendation.

Relevant time

21.25 In the case of a transaction at an undervalue, the relevant time would be a period of five years before the presentation of a petition to wind-up the company.

21.26 We received submissions which suggested that the relation back period for transactions at an undervalue of five years might be lengthened to up to seven years. We are inclined to retain the 5-year limit for now. Experience may indicate that a longer or shorter period may be required, in which case an appropriate amendment may be made.

21.27 We received one submission which considered five years to be too long and which argued that significant adjustments in prices can change values at different times and that wide fluctuations in prices can occur within a short period of time. We accept that prices fluctuate. A liquidator who sets out to challenge a transaction will only be likely to do so if the transaction price varies considerably from the market price prevailing at the time and where the liquidator can demonstrate, with the aid of expert valuations, that the price did not reflect the market price. Companies, and particularly person connected with companies, should be careful to document transactions so as to avoid charges that they entered into transactions at an undervalue or overvalue with the company. We find this to be an entirely reasonable expectation.

Court orders in respect of unfair preferences and transactions at an undervalue / overvalue

21.28 The Bankruptcy Ordinance, section 51A, sets out the various orders that the court may make. Orders made under section 51A apply to both transactions at an undervalue and unfair preferences. The intention of the section, however, is not to limit the power of the court but to make provision for cases where:

> *"a company's obligation is backed by a surety or guarantor. For example, a payment may have been made to a creditor with a view to releasing the surety or guarantor rather than preferring the creditor, and the creditor may have released the guarantee and returned any security given before the payment is struck down as a preference. The creditor would then in all probability have had no remedy against the guarantor."* [291]

Third parties may be affected

21.29 Under the Bankruptcy Ordinance, section 51A(2), third parties involved in a transaction involving an unfair preference or a transaction at an undervalue may be affected. The equivalent provision under the Insolvency Act is section 241(2), about which the following comment has been made:

> *"This sub-section allows third parties to be brought into the proceedings and orders to be made against them or their property instead of, or as well as, against the party with whom the company has dealt in the transaction under challenge. In particular, it will enable an order for repayment to be made directly against a surety or guarantor when the real object of a payment made by the company to a particular creditor was to release the guarantee rather than prefer the creditor. Bona fide third parties acquiring property or benefits for value will, however, be protected. Nevertheless, the concluding words of (section 51A(2)(b)) indicate that the person who was the actual counterparty to a transaction at an undervalue or who himself, as a creditor, received the benefit of a preference will not be protected merely because he acted in good faith and for value. (This is in keeping with the traditional view taken in relation to fraudulent preferences, that it is the intention of the company to give an improper preference which is crucial, and that the state of mind of the creditor himself is immaterial.)"* [292]

21.30 We received a submission from the Hong Kong Association of Banks which stated that:

> *"The new section 51A(2)(b) of the Bankruptcy Ordinance protects a third party (other than the person preferred) who received a benefit from an unfair preference 'in good faith and for value' from being required to make a refund to the trustee. Sub-section (3) goes on to provide, in a complicated manner, for a presumption against good faith, unless the contrary is shown, where such third party had notice of the circumstances which amounted to the giving of the unfair*

[291] *Annotated Guide to the Insolvency Legislation*, L. S. Sealy and David Milman, 4th Edition, page 296.

[292] *Annotated Guide to the Insolvency Legislation*, L. S. Sealy and David Milman, 4th Edition, pages 296 and 297.

preference, or presentation of the bankruptcy petition or making of the bankruptcy order. If this is intended to provide a defence to an innocent third party, such as a bank which was repaid as a result of the debtor's desire to prefer a connected guarantor, it is not clear that it works. It is to say the least unclear how these provisions operate. It is stated in at least one textbook that a bank in such a case would have no defence. If the person preferred is the guarantor, an order should be made against that guarantor to restore the position, and not against the bank, which is then left to try, if it can, to recover from the guarantor. The fact that the recipient of the benefit is the third party is not relevant, since, as pointed out on page 123 of the Consultation Paper, the third party may well have used the money to pay his own creditors.

In relation to a transaction at an undervalue, the 'good faith and for value' defence does not apply, as the bank would be a party to the transaction, e.g., as the beneficiary of a guarantee given by the company. A transaction (e.g. the giving of a guarantee) is at an undervalue if the value of the consideration received by the guarantor is sufficiently less than the value of the consideration provided by the guarantor (in the form of the guarantee). Re M C Bacon[293] held, among other things, that the granting of a debenture to secure a company's own debt could not be valued in money's worth and that the transaction was not at an undervalue. It has been suggested that this does not apply where the security or guarantee is granted in respect of another party's debt. The decision itself is also questioned (Paget's Law of Banking, 11th Edition, p. 210). The defence under section 238(5) (entered into in good faith, for the purpose of carrying on the company's business, and for its benefit) of the Insolvency Act 1986 is not available in the case of a personal bankruptcy.

It appears that in many cases relating to a (third party) security or guarantee in the ordinary course of business there would be an undervalue. The position of third parties such as banks in relation to the taking of securities or guarantees need to be clarified: such a transaction, if it is undertaken in the ordinary course of business, should not be put at risk nor be lightly set aside."

21.31 We note the concern of the Hong Kong Association of Banks but we are not inclined to make a recommendation at this point to exclude banks and other parties who take security and guarantees. There is obviously a continuing debate on the subject which will no doubt be resolved. We note the comment from *Paget's Law of Banking* referred to in the submission, which states that:

"*In Re M C Bacon Limited, Millet J. held that the mere creation of a security could not be categorised as a transaction at an undervalue since it did not deplete the company's assets and that the company did not provide a consideration which could be measured in money or money's worth. It is questionable whether this is right. By granting the charge the company gives value to the bank. That value could be measured in money's worth as additional costs are unsecured as opposed to secured lending. If that were right, then banks which take*

293 *Re M C Bacon* [1990] BCLC 324.

charges from customers by way of security within the relevant time could find the charges are challenged as transactions at an undervalue. If a charge is granted as security for past consideration (in which event it may also be a preference, or voidable floating charge), then it is arguable that the company receives no consideration for the charge. It is likely that the consideration received by the company is the continuation of the banking facilities. If the charge is granted by way of a security for future and past debts, then if the past debts are significantly greater than the future advances made by the bank, the transaction is a prima facie a transaction at an undervalue. Again, it is likely that banks will rely upon section 238(5), and the fact that the company received the benefit of the bank continuing its banking facilities."

Insolvent trading

21.32 The Commission, in its *Report on Corporate Rescue and Insolvent Trading*, recommended that directors and senior management of a company should be made liable for any debts of a company which arose when a company traded while it was insolvent. This recommendation, when introduced into legislation, would complement the unfair preference and transactions at an undervalue provisions. The *Report* noted that it was not the intention of the Commission for a provisional supervisor to get involved in insolvency issues and the *Report* recommended that the unfair preference and transactions at an undervalue recommendations should not apply in cases where a company went into provisional supervision.[294] The matter would be left to the liquidator if the provisional supervision failed and the company was wound-up.

21.33 We maintain this recommendation. We received some submissions on the recommendation, which, in part, related to the insolvent trading recommendations themselves. As we understand that the Secretary for Financial Services has recently circulated proposals relating to draft legislation for Corporate Rescue and Insolvent Trading which should be brought before the Legislative Council in 1999, we have passed on the submissions for the purposes of that legislation.

21.34 One submission suggested that the relevant date for the liquidation, if a provisional supervision failed and the company was liquidated, for actions relating to transaction at an undervalue, preferences and others such as setting aside a floating charge (and perhaps for disqualification of directors) should be the date that the provisional supervision commenced, with which we agree. If this is not the case, creditors may reject an otherwise workable provisional supervision in order to appoint a liquidator to attack actions which would otherwise fall outside the time period and the directors of a company might promote provisional supervision for the same reason.

Transactions at an undervalue / overvalue and the Conveyancing and Property Ordinance

21.35 Section 60 of the Conveyancing and Property Ordinance provides for the voidability of dispositions to defraud creditors. Every disposition of property made

[294] *Report on Corporate Rescue and Insolvent Trading*, paragraph 19.10 to 19.13.

with intent to defraud creditors is voidable but the section does not extend to any estate or interest in property disposed of for valuable consideration and in good faith, or upon good consideration and in good faith to any person not having, at the time of the disposition, notice of the intent to defraud creditors.

21.36 The *Consultation Paper* noted this provision, stating that, while there should be no conflict between the provision and the recommendation on transactions at an undervalue, notice should be taken of this provision in drafting a provision on transactions at an undervalue.

21.37 We received a submission that it might be appropriate to introduce a provision along the lines of sections 423 to 425 of the Insolvency Act 1986, regarding transactions intended to defraud creditors. These provisions revamped provisions which correspond to section 60 of the Conveyancing and Property Ordinance and widen the provisions to cover, for example, payments of money, whereas section 60 relates only to fraudulent conveyances of property.

21.38 We consider that it would be useful to bring provisions relating to fraudulent transactions at an undervalue within the provisions of the Companies Ordinance and, accordingly, we **recommend** the adoption of the widened provisions of sections 423 to 425 of the Insolvency Act. Consideration should also be given to expanding these provisions to take account of fraudulent transactions at an overvalue. We suggest that the wording of the equivalent of section 423 should be "*Transactions intended to defraud the claims of creditors*" as opposed to "*Transactions defrauding creditors*".

21.39 Section 423 of the Insolvency Act provides that a person enters into a transaction at an undervalue when he makes a gift to the other person or he otherwise enters into a transaction with the other on terms that provide for him to receive no consideration (we would prefer the use of the words "*no sufficient consideration*"), where he enters into a transaction with the other in consideration of marriage, or where he enters into the transaction with the other for a consideration the value of which is significantly less than the value of the consideration provided by himself.

21.40 The court may make orders restoring the position to what it would have been if the transaction had not been entered into and to protect the interests of persons who are the victims of the transaction if the court is satisfied that the transaction was entered into for the purposes of putting assets beyond the reach of a person who had a claim against the defrauding person or if the transaction otherwise prejudiced the interests of such a person in relation to such a claim. An application could be made under this section by a liquidator of a company, the provisional supervisor, or by the victim of the transaction, with the consent of the court. This provision might also be applied to the Bankruptcy Ordinance.

Section 267 Effect of floating charge

21.41 The section provides that, where a company is being wound-up, a charge which, when created, was a floating charge on the undertaking or property of the company and which was also created within 12 months of the commencement of the winding-up shall, 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 the less.

21.42 The Hong Kong Association of Banks submitted that:

> *"Section 267 contains an exception for new money advanced to the company at the time of or after the creation of the floating charge. When bankers take security for a running account, payments into the account will discharge prior indebtedness and payments out will constitute new advances secured by the floating charge. This section should be preserved as the lending banker is continuing facilities to the company which might otherwise be withdrawn, resulting in liquidation, when given time, the company may survive."*

21.43 The Official Receiver's Office submitted that:

> *"Section 267 should be replaced by a provision along the lines of section 245 of the Insolvency Act 1986. That section expressly covers benefits conferred on a company otherwise than by the payment of cash. The 12-month period is extended to two years if the chargee is a person connected with the company. The exception where the company is proved at the material time to have been solvent will not be available to such a chargee."*

21.44 The *Consultation Paper* proposed and we **recommend** that the effect of the provision should be extended from 12 months to two years in the case of persons who are connected to the company.[295] The recommendation followed a similar provision under section 245(3) of the Insolvency Act.

21.45 We received a submission that benefits in terms of property, which is not limited only to goods but also cover things such as securities and services supplied, should be included in addition to cash paid. We support this submission and **recommend** its adoption.

21.46 We received a submission that a provision should be introduced along the lines of section 245(2)(b) of the Insolvency Act to the effect that the value of consideration which consists of the discharge or reduction, at the same time, or after, the creation of a charge, of any debt of a company, should not be treated as invalid. We **recommend** the adoption of this submission.

Super priority lending under provisional supervision

21.47 In the *Report on Corporate Rescue and Insolvent Trading*, the Commission made recommendations that would allow provisional supervisors to obtain loans which would be in priority to any other borrowing that the company in provisional supervision might have. We **recommend** that the provisions of section 267 should not apply to super priority borrowing in a provisional supervision.

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[295] See paragraphs 21.13 to 21.20.

Section 268 Disclaimer of onerous property in case of company wound-up

21.48 The section provides that a liquidator may, with the leave of the court, disclaim onerous property. This involves:

- land burdened with onerous contracts,
- shares or stock in companies,
- unprofitable contracts, or
- any property that is unsaleable, or not readily saleable, by reason of its binding the possessor to the performance of an onerous act, or the payment of a sum of money.

21.49 A liquidator must usually apply to the court to disclaim such property within 12 months of the commencement of winding-up but the court may extend the time period.

21.50 The Official Receiver's Office submitted that:

> *"Section 268 should be amended by the removal of the obligation to obtain the leave of the court. That would bring it into line with section 59 of the Bankruptcy Ordinance. In the Insolvency Act, sections 178 to 182, the liquidator does not need the leave of the court to disclaim."*

21.51 We support the submission and **recommend** that a liquidator should be able to disclaim property without having to apply to the court. In this context, we note that, under sub-section (4), a person interested in property may give the liquidator notice that he must within 28 days of the notice elect whether or not he wants to disclaim property, failing which the liquidator is deemed to have elected to have adopted the property.[296]

21.52 The disclaimer notice of a liquidator and the application by an interested party are in prescribed forms under the Insolvency Rules. The liquidator's notice should advise the person interested that he should apply to the court in respect of a disclaimer.[297]

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[296] The Companies (Winding-up) Rules, rules 63 and 64, would need to be amended accordingly.

[297] Insolvency Act, rules, 4.188 and 4.191.

Chapter 22 - Offences Antecedent to or In Course of Winding-up

22.1 The Official Receiver's Office has delegated authority from the Secretary for Justice to take prosecutions before a magistrate in relation to offences committed under various sections of the Companies Ordinance.

Section 271 Offences by officers of companies in liquidation

22.2 The section provides that if any past or present officer of a company which is being wound-up:

(a) *does not to the best of his knowledge and belief fully and truly discover to the liquidator all the property, real and personal, of the company, and how and to whom and for what consideration and when the company disposed of any part thereof, except such part as has been disposed of in the ordinary way of the business of the company; or*

(b) does not deliver up to the liquidator, or as he directs, all such part of the real and personal property of the company as is in his custody or under his control, and which he is required by law to deliver up; or

(c) does not deliver up to the liquidator, or as he directs, all books and papers in his custody or under his control belonging to the company and which he is required by law to deliver up; or

(d) within 12 months next before the commencement of the winding up or at any time thereafter conceals any part of the property of the company to the value of $100 or upwards, or conceals any debt due to or from the company; or

(e) within 12 months next before the commencement of the winding up or at any time thereafter fraudulently removes any part of the property of the company to the value of $100 or upwards; or

(f) makes any material omission in any statement relating to the affairs of the company; or

(g) knowing or believing that a false debt has been proved by any person under the winding up, fails for the period of a month to inform the liquidator thereof; or

(h) after the commencement of the winding up prevents the production of any book or paper affecting or relating to the property or affairs of the company; or

(i) within 12 months next before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates, or falsifies, or is privy to the concealment, destruction, mutilation, or falsification of, any book or paper affecting or relating to the property or affairs of the company; or

(j) within 12 months next before the commencement of the winding up or at any time thereafter makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company; or

(k) within 12 months next before the commencement of the winding up or at any time thereafter fraudulently parts with, alters, or makes any omission in, or is privy to the fraudulent parting with, altering, or making any omission in, any document affecting or relating to the property or affairs of the company; or

(l) after the commencement of the winding up or at any meeting of the creditors of the company within 12 months next before the commencement of the winding up attempts to account for any part of the property of the company by fictitious losses or expenses; or

(Note that section 271(1)(m) and (n) were repealed in 1970.)

(o) within 12 months next before the commencement of the winding-up or at any time thereafter pawns, pledges, or disposes of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging, or disposing is in the ordinary way of the business of the company; or

(p) is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them to an agreement with reference to the affairs of the company or to the winding up,

he shall, in the case of the offence mentioned in paragraph (o), be liable to imprisonment, and in the case of any other offence shall be liable to imprisonment and a fine.

22.3 The penalty under the section is a fine of up to $150,000 and imprisonment for up to six months on summary conviction or two years' imprisonment on indictment in respect of any offence under this provision, apart from offence (o) above under which a person may be imprisoned for two years on summary conviction or five years on indictment but there is no provision for a fine. It is interesting to note that the equivalent provisions under the Insolvency Act attract a term of imprisonment of up to seven years.

Offences to be separated into offences which occur before winding-up and those which occur in the course of winding-up

22.4 We note that the equivalent sections under the Insolvency Act, sections 206 and 208, are divided into offences antecedent to winding-up, under section 206, and offences in the course of a winding-up, under section 208. We **recommend** that, for clarity, it would be useful to separate the provisions in this way.

Few convictions

22.5 The terms of the section are wide-reaching and yet there have been no convictions under the section over the last several years. The Official Receiver has advised that prosecutions are sometimes taken under this section or section 274 in the alternative. Convictions, however, are inevitably made under section 274.

Burden of proof to be on the accused for certain offences

22.6 Sub-section (1) provides for certain offences by officers of a company in liquidation. The wording to the sub-section states that an officer "*shall be liable to imprisonment*", with or without a fine, depending on the offence. The proviso to the sub-section states, however, that it will be a good defence to a charge under any of offences (a), (b), (c), (d), (f) and (o), as set out above, if the accused proves that he had no intent to defraud, and to a charge under any of offences (h), (i) and (j), if he proves that he had no intent to conceal the state of affairs of the company or to defeat the law.

22.7 This wording differs from the wording of section 271 of the Companies Act 1929, from which the Companies Ordinance section 271 was taken, to the extent that section 271 of the Companies Act 1929 provided that an officer "*shall be guilty*" of a relevant offence but also made the same proviso that appears in section 271 of the Companies Ordinance. We have no explanation for the change in wording.

22.8 It is, we submit, understandable to provide for specific defences where there is a mandatory provision of guilt as in "*shall be guilty*" but the current provision provides for defences where there is no guilt deemed. It is unnecessary for the current provision, as worded, to have specified defences.

22.9 The *Consultation Paper* confused this issue when it stated that the equivalent provisions under the Insolvency Act, sections 206 and 208, shifted the burden of proof from the prosecution to the accused.[298] The *Consultation Paper* proposed that these provisions should be followed with the effect being that an accused had to prove that he had no intent to defraud, or, where appropriate, no intent to conceal the state of affairs of the company or to defeat the law.

22.10 It was pointed out by a submission that the *Consultation Paper* incorrectly gave the impression that the proposal was to reverse the burden of proof in respect of offences, the burden of proof of which now lies upon the prosecution. We acknowledge the correction. The submission continued:

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[298] See the Insolvency Act, section 206(4) and 208(4).

> " *In fact sections 206 and 208 of the Insolvency Act ... do no more than provide (as does the existing section 271 of the Companies Ordinance) that the accused has a good defence to the charges if he establishes, depending on the offence charged, either absence of intention to defraud or absence of intention to conceal the state of affairs of the company or defeat the law*."

22.11 In terms of offences committed before the winding-up, the Insolvency Act, section 206, places the onus of proving the absence of *mens rea* (intention) on the accused, that is he had no intent to defraud in respect of offences (d) and (o) of the Companies Ordinance above, and that the accused had no intent to conceal the state of affairs of the company or to defeat the law in respect of offences (i) and (j) of the Companies Ordinance.

22.12 In terms of offences committed in the course of the winding-up, the Insolvency Act, section 208, places the onus on proving the absence of an intent to defraud on the accused in respect of offences (a), (b) and (c) of the Companies Ordinance and that the accused had no intent to conceal the state of affairs of the company or to defeat the law in respect of offence (h) of the Companies Ordinance.

22.13 Where the burden of proof is shifted to an accused, his level of proof is " *on the balance of probabilities*" and not " *beyond a reasonable doubt*" , which would apply to the level of proof required of the prosecution.[299]

22.14 We **recommend** the adoption of the Insolvency Act provisions under sections 206 and 208 by placing the onus of proving the absence of intent to defraud or the absence of intent to conceal the state of the company or to defeat the law on the accused in respect of the offences set out in the paragraphs above.

22.15 We accept that the placing the burden on the accused of proving that he had no *mens rea* to commit an offence would amount to a significant policy change but we consider that the provision as it is currently worded serves no useful purpose. We find it unsurprising, however, that no prosecutions are brought under a section which specifies defences where there is no element of presumption of guilt. By adopting the Insolvency Act, sections 206 and 208, the deeming provision would be applied and the specified defences would be appropriate. In making this recommendation we would observe that the rights of the community have to be considered as well as the rights of the accused. In the case of this section as it stands the rights of the community are not being served.

Hong Kong Bill of Rights considerations

22.16 We consulted the Department of Justice on whether the adoption of the provisions on the burden of proof in sections 206 and 208 of the Insolvency Act would have implications under the Hong Kong Bill of Rights. The Department of Justice advised that article 11(1) of the Bill of Rights was relevant. Article 11(1) provides that:

> " *Everyone charged with a criminal offence shall have the right to be presumed innocent until proved guilty according to law*."

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299 *Morten v Confer* [1963] 1 WLR 763.

22.17 The Department of Justice advised that in respect of any departure from the principle that it was for the prosecution to prove the guilt of the accused beyond a reasonable doubt is *prima facie* in conflict with Article 11(1) but that the rights and freedoms guaranteed by the Hong Kong Bill of Rights were not absolute. In *Attorney General v Lee Kwong Kut*[300] the Privy Council said that:

> " *Some exceptions will be justifiable, others will not. Whether they are justifiable will in the end depend upon whether it remains primarily the responsibility of the prosecution to prove the guilt of the accused to the required standard and whether the exception is reasonably imposed, notwithstanding the importance of maintaining the principle which article 11 enshrines. The less significant the departure from the normal principle, the simpler it will be to justify an exception. If the prosecution retains responsibility for proving the essential ingredients of the offence, the less likely it is that an exception will be regarded as unacceptable.*"

22.18 There is precedent for placing a burden of proof on the accused in legislation currently in force. The Import and Export Ordinance (Cap. 60), section 18A(2), provides that an accused person who (i) has possession of any cargo; (ii) assists with the carrying, removing, depositing, harbouring, keeping or concealing of any cargo or otherwise deals with any cargo, in circumstances that give rise to a reasonable suspicion that there is an intent on the part of another person to export the cargo without a manifest, will be presumed to have such an intent in the absence of evidence to the contrary. The Import and Export Ordinance, section 35A(2), has a similar presumption with regard to assisting in the carriage of prohibited articles.

22.19 These sections have been considered by the Court of Appeal which ruled that the presumptions imposing an evidential burden on the accused in sections 18A(2) and 35A(2) of the Import and Export Ordinance were consistent with the Hong Kong Bill of Rights.[301] The Court of Appeal in another case, *R v Li Tat*[302] applied the test in *Attorney General v Lee Kwong Kut* and upheld a provision in the Import and Export Ordinance which shifted the burden of proof onto the accused. The court considered that the Government had no prospect whatever of proving the relevant matters which were within the knowledge or control of the accused and that the enforcement of the import and export quota was a matter of importance to the community.

22.20 The Court of Appeal also applied the test in *Attorney General v Lee Kwong Kut* in ruling that the terms of the Prevention of Bribery Ordinance (Cap. 201) , section 10(1), was consistent with the Hong Kong Bill of Rights.[303] Section 10(1) provides, in essence, that a Government servant who maintains a standard of living above that which is commensurate with his official income shall be guilty of an offence unless he gives a satisfactory explanation as to how he is able to maintain such a standard of living.

22.21 We consider that the test imposed by the Privy Council in *Attorney General v Lee Kwong Kut* is satisfied in the recommendation for placing the burden on the accused in respect of the offences under the Companies Ordinance referred to above. It would remain primarily the responsibility of the prosecution to prove the

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300 (1993) 3 HKPLR 72, at page 94.

301 *The Queen v Wong Hiu-chor and Others* [1993] 1 HKCLR 107.

302 (1993) 3 HKPLR 171.

303 *Attorney General v Hui Kin Hong* (1995) 5 HKPLR 100.

guilt of the accused to the required standard. We are of the view that the comments made by the Court of Appeal in another case, *R v Li Tat*, that the Government had no prospect whatever of proving the relevant matters which were within the knowledge or control of the accused in relation to the enforcement of the import and export quota applies equally to the offences under section 271. The matter speaks for itself. There are no prosecutions brought under the section.

22.22 If the shifting of the burden recommended is not accepted, we suggest that provision might be made to raise presumptions about certain situations, similar to the insolvent trading recommendations in the *Report on Corporate Rescue and Insolvent Trading*.[304]

Concealing of property

22.23 Section 271(1)(d) provides that if within 12 months before winding-up or at any time after winding-up, an officer conceals property of the company to the value of $100 or more, he is guilty of an offence and may be prosecuted.

22.24 We consider that it is inappropriate to place a monetary value on the property as, for instance, company papers of no monetary value to anyone else might be of considerable value to the company. We **recommend** that the reference to a monetary value should be removed.

Section 273 Frauds by officers of companies which have gone into liquidation

22.25 The section provides that:

> *"If any person, being at the time of the commission of the alleged offence an officer of a company which is subsequently ordered to be wound up by the court or subsequently passes a resolution for voluntary winding-up:*
>
> *(a) (Repealed 21 of 1970 s. 35)*
>
> *(b) with intent to defraud creditors of the company, has made or caused to be made any gift or transfer of or charge on, or has caused or connived at the levying of any execution against, the property of the company;*
>
> *(c) with intent to defraud creditors of the company, has concealed or removed any part of the property of the company since, or within two months before, the date of any unsatisfied judgment or order for payment of money obtained against the company,*
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> *he shall be guilty of an offence and liable to imprisonment and a fine."*

22.26 The penalty under the section is a fine of up to $50,000 and imprisonment for up to six months on summary conviction or a fine of $150,000 and

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304 See paragraphs 19.49 to 19.55 of the *Report* and note the recommendations on the payment of compensation by directors at chapter 28 of this report.

up to two years' imprisonment on indictment in respect of an offence under this provision.

22.27 As with section 271, the Insolvency Sub-committee proposed that the burden of proof[305] should be shifted onto an accused to the effect that the accused would not be guilty of an offence if he proved that, at the time of the conduct constituting the offence, he had no intention to defraud the company's creditors.

22.28 In this instance, we are concerned about placing an onus of proof on the accused, notwithstanding that the proposals of the Insolvency Sub-committee do not contravene the Hong Kong Bill of Rights, as a reversal of the onus of proof in respect of some of the offences under section 273 might be unfair to the accused. The nature of the offences in section 273 are different to those in section 271 as some relate to actions that would, on the face of it, constitute legitimate actions in normal circumstances. We have therefore considered the offences set out in section 273 individually. We **recommend** that the offences should be set out in the manner of the offences under section 271.

22.29 Sub-section (b) refers to an accused with intent to defraud creditors of the company, causing to be made any (i) gift of, (ii) transfer of, or (iii) charge on the property of the company. A gift of property of the company is by its nature an action that would give rise to a legitimate suspicion and it is reasonable to require an accused to justify the making of the gift in all the circumstances of a particular case. We **recommend** that the test of "*an intent to defraud*" should be removed from the provision and that it should be replaced by a test of whether "*without reasonable excuse*" a gift was made with the onus being placed on an accused to proving that there was a reasonable excuse for the gift having been made. In the absence of a reasonable excuse an accused may be guilty of an offence. We consider that the test of "*without reasonable excuse*" would be a less severe test than that of "*intent to defraud*".

22.30 Sub-section (b) also refers to two other actions, that of with the intent to defraud creditors, transferring or charging property of the company. Transfers or charges are by their nature actions which would be expected to arise in the ordinary course of business. We are not prepared to change the onus of proof in respect of such actions. We **recommend** that the test of "*an intent to defraud*" should be removed and replaced with a test of "*without reasonable excuse*".

22.31 Sub-section (b) finally refers to a crime of with intent to defraud, causing or conniving at the levying of an execution against the property of the company. We would categorise this offence with the making of a gift as being involved in the levying of an execution against a company is by its nature an action that would give rise to a legitimate suspicion and it is reasonable to require an accused to justify his actions. We **recommend** that the test of "*an intent to defraud*" should be removed and that it should be replaced by a test of whether "*without reasonable excuse*" an accused caused or connived in the levying of an execution, with the onus being placed on the accused to prove that there was a reasonable excuse.

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305 See the recommendations on the burden of proof under section 271, at paragraphs 22.6 to 22.22.

22.32 We **recommend** that the offence under sub-section (c) should be removed to section 271 and should be subject to the onus of proof being placed on an accused that he had not intended to defraud creditors of the company.

Section 274 Liability where proper accounts not kept

22.33 This section provides that in a winding-up where, in most cases, it is shown that proper books of account were not kept by the company throughout the two years before the commencement of the winding-up, every officer in default shall, unless he shows that he acted honestly and that in the circumstances the default was excusable, be guilty of an offence.

22.34 The penalty under the section is a fine of up to $50,000 and imprisonment for up to six months on summary conviction or a fine of $150,000 and up to two years' imprisonment on indictment in respect of an offence under this provision. A conviction under this section constitutes grounds for determining whether or not a director is unfit to be a director under the fifteenth schedule and section 168H. In 1996/97, 14 directors were disqualified under sections 121 and 274, for periods of between one and three years. In 1997/98, 30 directors were disqualified under these sections for periods of between one and four years.[306]

Prosecution of offences

22.35 The Official Receiver's Office's analysis of prosecutions over the four years from 1993/94 to 1997/98 shows that there were no prosecutions taken in respect of any of the sections 271 to 275 apart from section 274. Section 274, which provides for the liability of officers where proper books of account were not kept in the two years before the commencement of the winding-up, is closely related to section 121, which provides for the keeping of books of account by companies at all times. The Official Receiver's Office's figures for 1993/94 and 1994/95 combined the prosecutions under these two sections. Over those two years, there were a total of 84 summonses issued under the sections, of which 67 resulted in successful prosecutions with an average fine of almost $8,900.[307]

22.36 The year 1995/96 was the first year that sections 121 and 274 were distinguished. Under section 274, there were 25 summary convictions resulting in average fines of $7,300. In 1996/97, the first year when the new penalty amounts had application, there were 13 summary convictions resulting in average fines of nearly $3,600. In 1997/98, there were 12 summary convictions resulting in average fines of $2,233.

22.37 It is interesting to note that even though the amount of the penalty under section 274 has been doubled, the average fine had decreased significantly in the two years since they were introduced. Several factors need to be taken into account. All cases are different and there is no way of distinguishing the particulars of each case from the statistics. Some of the cases in 1996/97 would have been

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306 *Official Receiver's Office Annual Departmental Reports for 1996/97 and 1997/98*, Annex 16.

307 At that time the maximum fine that could be imposed was $25,000 on summary conviction under section 274 and $200,000 under section 121. The new level of fines quoted in the sections below came into effect in July 1996 (See L. N. 306 of 1996). The maximum penalty under section 121 is now $300,000.

decided and fines would have been imposed under the old penalty tariff but the figures for 1997/78 tend to suggest that magistrates are unwilling to impose meaningful fines.

22.38 While figures can be misleading, we are concerned that even in 1995/96, fines only reached 29 per cent of the maximum tariff and that figure is lower in 1996/97. While it must be assumed that the level of the fines being imposed by the court reflects the seriousness of the offence, it is open to question whether the level of fines is any deterrent to directors who might be tempted to commit an offence under the provisions in general, in the knowledge that, at worst, they will be subject to a modest fine.

22.39 We received a submission from the Securities and Futures Commission (SFC) that:

> " ... *penalties levels must be set in a manner which makes clear the seriousness with which the offences are regarded by society and by the legislature. If the courts consistently impose fines which are regarded as inadequate to present any element of deterrent, which appears to the [Securities and Futures] Commission to be the case, then the maximum penalty must be increased so that a court, in arriving at the appropriate penalty, will start with a higher figure (reserved for the worst examples of offences of that kind) and reduce it according to the gravity of the particular offence, having regard to any mitigating factors*."

22.40 We agree entirely with the SFC. The levels of penalties that magistrates seem to be prepared to impose are plainly inadequate. It appears to be cheaper for directors to fail to comply with their statutory obligations than to comply with them. If the courts consider that an average fine of $2,233 in the year 1997/98 in relation to convictions under section 274 is adequate we consider that they must be out of step with the intention of the legislature and we question whether proper consideration is being given to the seriousness of the offence. An average fine of $2,233 is 4.4% of the maximum fine.

22.41 It is also worth noting that a conviction under section 274 will almost automatically mean that a convicted director will be further prosecuted under section 168H to have him disqualified from acting as a director.

22.42 The Official Receiver's Office advised that prosecutions had not been taken under sections 271 to 273 and 275 because no cases had been referred to the Official Receiver's Office that could be carried through to a prosecution. Cases may be referred to the prosecution section either by the Official Receiver's Office insolvency officers or by private sector liquidators.

22.43 The Official Receiver's Office advised that prosecutions under section 274 came to the attention of liquidators more easily as directors were obliged to produce a statement of affairs. If there were no accounts available to prepare a statement of affairs the fact was usually brought to the attention of the Official Receiver's Office.

22.44 We received a submission from the Hong Kong Police Force which suggested that if the maximum punishment for dishonestly altering accounting record was 10 years' imprisonment under section 19 of the Theft Ordinance (Cap. 210), failing to keep proper accounting records, which should be a more serious

misconduct, should attract a similar level of punishment to deter such attempts. The submission suggested that the maximum punishment provided for under section 274 should be 10 years' imprisonment on indictment.

22.45 We do not agree with the Police that a failure to keep proper accounts is a more serious misconduct than dishonestly altering accounting records; the one being an act of omission, the other being a dishonest act of commission. We do not support the suggestion of 10 years' of imprisonment on conviction. The provision should, however, be enforced by magistrates. The legislation provides criteria within which magistrates judge an offence and the magistrates should award a penalty to suit the case. We find it difficult to believe that this is happening.

Proper books of account

22.46 Sub-section (2) provides that:

> *"For the purposes of the section, proper books of account shall be deemed not to have been kept in the case of any company if there have not been kept such books or accounts as are necessary, to exhibit and explain the transactions and financial position of the trade or business of the company, including books containing entries from day to day in sufficient detail of all cash received and cash paid, and, where the trade or business has involved dealings in goods, statements of the annual stocktakings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified."*

22.47 The definition of "*proper books of account*" under sub-section (2) is clearly intended to comprehensively cover all forms of account and trade practice. The *Consultation Paper* proposed that the definition might usefully be expanded to make reference to computerised books of account. The *Consultation Paper* hesitated in this regard as it noted that a number of successful prosecutions had been brought under this section and section 121 in recent years. The *Consultation Paper* sought comments on whether the present wording might be considered to be out of date or whether it was adequate for present day needs.

22.48 Submissions generally supported expanding the definition to computer records but one submission pointed out that companies could meet the requirements of keeping proper books and records by keeping the records on computer, but unless a liquidator had access to the software programs the computer information was useless and unreadable.

22.49 We take this point. We **recommend** that the definition of proper books of account should include computer records but that they should be defined as only supporting the primary record, which should consist of a hard copy print out.

22.50 We also **recommend** that the primary books of account should not be deemed to be proper books of account unless they are maintained in a manner that would exhibit and explain "*at any reasonable time*" the transactions and financial position of the trading business of a company.

22.51 We note that the definitions of proper books of account under section 121(1) and section 274 are different. We **recommend** that the two definitions should be the same.

Section 275 Responsibility of directors for fraudulent trading

22.52 The section provides that if in the course of the winding-up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or others, the court, on the application of the Official Receiver, the liquidator, any creditor, or contributory of the company, may declare that any persons who were knowingly parties to the carrying on of the business in such a way shall be personally liable, without limitation, for all or any of the debts or other liabilities of the company.

22.53 In addition to an unlimited civil liability, it is also a criminal offence to carry on a business with the intention to defraud any person for which the penalty is a fine of up to $100,000 and imprisonment for up to 12 months on summary conviction or an unlimited fine and up to five years' imprisonment on indictment.

Insolvent trading

22.54 We refer to the Commission's comments on fraudulent trading in the *Report on Corporate Rescue and Insolvent Trading*.[308] The Commission recommended the introduction of a civil remedy, to be known as insolvent trading, under which the directors and senior management of a company could be held personally liable for the debts incurred by a company during the time when it traded while insolvent.[309]

22.55 These recommendations have not yet been brought before the legislature. We believe that if the insolvent trading recommendations are adopted into legislation, civil cases in respect of fraudulent trading are unlikely to be taken as the standard of proof under insolvent trading would be easier to establish.

22.56 One of the problems with fraudulent trading is that the courts have imposed the criminal standard of proof on the proceedings to the effect that a plaintiff whose principal interest is in recovering assets and not in punishing a defendant with a fine or imprisonment, is still obliged to prove his case beyond a reasonable doubt instead of on a balance of probabilities.

22.57 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.[310] The plaintiff must prove that:

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

[308] *Report on Corporate Rescue and Insolvent Trading*, paragraphs 19.114 to 19.116. Insolvent trading is the equivalent of wrongful trading under section 214 of the Insolvency Act and insolvent trading under section 588G of the Australian Corporations Law.

[309] *Report on Corporate Rescue and Insolvent Trading*, chapter 19.

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

(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

(i) 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

(ii) 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.

22.58 The *Consultation Paper* preferred not to make any proposals for change to the provisions on fraudulent trading as the Insolvency Sub-committee believed that the insolvent trading recommendations would displace the civil liability side of fraudulent trading. The *Consultation Paper* suggested that the only change that might be considered would be removing the criminal sanction from the section, making it a civil issue and creating a less onerous standard of proof for a plaintiff.

22.59 The *Consultation Paper* anticipated, however, that the civil remedy in future would be provided by insolvent trading. The *Consultation Paper* preferred to retain the criminal aspect of fraudulent trading as it was important that those who participated in fraudulent trading should be aware that the penalty for such behavior might go beyond financial penalty and could result in imprisonment and sought comments on how fraudulent trading should be dealt with in the future on the basis that insolvent trading would be introduced in legislation.

22.60 A number of submissions were received all of which supported the retention of the criminal aspects of fraudulent trading and we therefore do not make any recommendation in respect of this section, which should remain as it is.

Section 276 Power of court to assess damages against delinquent officer, etc.

22.61 The effect of the provision is that, in a winding-up, the court may examine any person who took part in the formation or promotion of the company, any past or present officer, and any liquidator or receiver of the company, for misfeasance or breach of duty or trust in relation to the company.

22.62 If the court finds that a person examined has been guilty of a misfeasance or breach of duty, it may compel that person to repay or restore the money or property, plus interest, or to contribute such sum to the assets of the company by way of compensation as the court thinks just.

22.63 The Official Receiver has confirmed that no action has been taken by the Official Receiver in recent years and practitioners have also confirmed that the provision was rarely used.

22.64 This is not the case, however, with the Insolvency Act equivalent, section 212, which replaced the Insolvency Act's equivalent of section 276 of the Companies Ordinance. Though similarly worded, section 212 refers to "*breach of fiduciary or other duty*" whereas section 276(1) refers to both "*breach of duty*" and "*breach of trust*". While the wording might appear to have the same effect, the courts of England and Wales have held that the equivalent of the present wording of section 276(1) did not include claims based on negligence.[311] More recently, the courts of England and Wales have held that the section now covered breaches of any duty, including a duty of care.[312]

22.65 We approve of this expansion of the effect of the provision and **recommend** that it should be adopted. This would also have the beneficial effect of clarifying the confusing references to duty and trust under the current provisions. We note that the provision would complement the recommendations on specific duties of care to be imposed on liquidators.[313]

Provisional supervisors

22.66 The section should apply to provisional supervision for two reasons. First, if a provisional supervisor uncovers matters that would come under section 276, as things stand, no action could be taken until the company was wound-up and then action would be taken by the liquidator. We **recommend** that a provisional supervisor should be able to take appropriate action under the section.

22.67 Second, if a company in provisional supervision was subsequently wound-up and the liquidator found that the provisional supervisor had been involved in activities that would come under section 276, it would be appropriate, and we **recommend** that, the provisional supervisor should be vulnerable to action being taken against him under the section.

Section 277 Prosecution of delinquent officers and members of company

22.68 The section provides that if it appears to the court, in the course of a winding-up by the court, that any past or present officer or member of the company has been guilty of any offence in relation to the company for which he is criminally liable, the court may direct the liquidator to refer the matter to the Secretary for Justice.

22.69 Prior to the publication of the *Consultation Paper,* the Hong Kong Police Force submitted that:

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311 *Re B Johnson & Co. (Builders) Ltd* [1955] Ch. 624.

312 *Re D'Jan of London Ltd* [1993] BCC 646.

313 See paragraph 12.53.

"In the present legislation, there is no statutory requirement for a liquidator to inform police of any malpractice or criminality he may find in the affairs of a company being wound up. It is felt that the number of liquidations are limited and the benefits of learning at an early stage of criminality within a company under liquidation substantial."

22.70 In a voluntary winding-up, a liquidator is obliged similarly to report the matter to the Secretary for Justice and to furnish the Secretary for Justice with all relevant information. In a voluntary winding-up the court may, if a matter that should be reported to the Secretary for Justice is brought to his attention, direct a liquidator to report the matter to the Secretary for Justice.

22.71 The Hong Kong Society of Accountants advised that, on the issue of crime, it was difficult to generalise given that offences could range from theft of a few minor items to fraud. The Society recognised that for substantial matters there was an overriding obligation under section 277 to bring the matter to the attention of the Secretary for Justice and the Society added that, in practice, reports would be more likely made to law enforcement agencies, such as the Commercial Crime Bureau or to a regulator, such as the Official Receiver.

22.72 The Society has issued a *Professional Ethics Statement* on "*Unlawful acts or defaults by clients of members*" which deals primarily with the auditor and client relationship, which states specifically that an appointment as liquidator does not give rise to a similar professional to client relationship. The *Ethics Statement* states that in a liquidation, an auditor should make information available to the liquidator, whose decision it should be whether or not to make a report under section 277.

22.73 The Society concluded that members had noted that the whole question of reporting crime could give rise to a conflict of interest, given a liquidator's duty to act in the best interests of the creditors, as it would not always be clear that reporting a suspicion that a criminal offence had been committed would be to the benefit of the creditors.

22.74 We have commented elsewhere on the unsatisfactory level of prosecutions of directors and on the need for a general reconsideration of how dishonesty on the part of company directors might be addressed more effectively.[314]

22.75 While we accept that liquidators may encounter conflicts between the reporting on crime and acting in the interests of creditors, we consider that the reporting of crime should attract a higher priority than appears to be the case at present.

22.76 We can only speculate as to how many crimes go unreported by liquidators, but we must assume that in the absence of a clear policy of reporting crime whenever it is encountered, liquidators will decide not to get involved in the reporting of a crime if it is likely to cost too much or is likely to get in the way of the primary purpose of pursuing assets.

22.77 Indeed, we accept that the recommendations on examinations under sections 221 and 222 contemplate that answers given under examination should not be capable of being used in criminal proceedings against the person being examined.

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[314] See paragraphs 22.35 to 22.45 and the recommendations on the payment of compensation by directors at paragraphs 28.11 to 28.16.

The idea behind the recommendation is that a liquidator's primary function is to recover assets for the benefit of creditors. This is a legitimate aim but a liquidator could be forgiven for thinking that if the legislation was to make a provision of this nature, why should he bother to report a crime.

22.78 The establishment of the Official Receiver's administrative scheme for the licensing of insolvency practitioners would provide an opportunity for the Official Receiver, in conjunction with the Hong Kong Society of Accountants, the Law Society and the Hong Kong Institute of Company Secretaries, in discussion with the Hong Kong Police Force, to consider how insolvency practitioners should approach a suspected crime situation.

22.79 We consider that it would not be appropriate to make provision in the Companies Ordinance for imposing obligations to report crimes on insolvency practitioners. We **recommend** that it would be appropriate for the Official Receiver, in conjunction with the licensed bodies, to set down a code of practice giving guidance to insolvency practitioners in situations where they become aware of criminal conduct. Under the Official Receiver's current scheme for appointing private sector liquidators, liquidators are obliged to carry out a minimum standard of statutory investigation into the affairs of a company. [315]

22.80 We **recommend** that suspected crimes might be reported initially to the Official Receiver as the regulator of the Administrative Panels so that the Official Receiver could consider whether to advise the liquidator to report the matter to the Secretary for Justice or for the Official Receiver to refer the matter to the Secretary for Justice or the Police, as appropriate, directly.

22.81 We received a submission from the Hong Kong Society of Accountants which stated that the Society's Insolvency Practitioners' Committee had noted that the whole question of reporting crime could give rise to a conflict of interest, given a liquidator's duty to act in the best interests of the creditors. The submission added that it would not always be clear that reporting a suspicion that a criminal offence had been committed would be to the benefit of the creditors.

22.82 We note this submission with some concern. We would like to make it clear that in the context of the winding-up of companies as a whole there is an independent public interest in liquidators reporting suspected crimes to the appropriate authorities. This would equate with the Hong Kong Society of Accountants' comment within the submission that there was an overriding obligation under section 277 to bring substantial crimes to the attention of Secretary for Justice.

"Has been guilty"

22.83 Under sub-sections (1) and (2), references are made to cases where it appears that an officer or a member of a company "*has been guilty*" of an offence for which he is criminally liable, a form of wording that is also used in section 218 of the Insolvency Act. It has been suggested that the emphasis of the wording is misleading as it gives the impression that the officer or member has already committed an offence for which he has been convicted.

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315 Note the recommendations on the licensing of insolvency practitioners under Chapter 3.

22.84 Clearly the intention of the sub-sections is to provide for cases where an officer or member "*may have committed*" an offence. We **recommend** that the wording of the section be amended to properly reflect the intention of the provisions.

Chapter 23 – Supplementary Provisions as to Winding-up and Supplementary Powers of Court

Section 278 Disqualification for appointment as liquidator

23.1 The section provides that undischarged bankrupts and bodies corporate are disqualified from being a liquidator in a winding-up of a company. If any such appointment is made it shall be void and the bankrupt or body corporate would be subject to a fine of up to $150,000.

23.2 The recommendations on the licensing of insolvency practitioners would change the character of the section but it would still remain relevant as regards insolvency practitioners themselves and it would also be relevant if the recommendations on the licensing of insolvency practitioners are not adopted in their entirety.[316]

Unqualified person not to act as an insolvency practitioner
Bodies corporate, bankrupts, persons of unsound mind and persons disqualified from acting as a director not to act as an insolvency practitioner

23.3 The Insolvency Act, section 389, provides that a person who acts as an insolvency practitioner in relation to a company or an individual when he is not qualified to do so is liable to imprisonment and a fine. The Official Receiver is specifically excluded from the provision. The Insolvency Act, section 390, provides that a person who is not an individual, that is, a body corporate, is not qualified to act as an insolvency practitioner and the disqualification also applies to bankrupts, persons of unsound mind and persons disqualified from acting as a director. We **recommend** that these provisions should be adopted in the Companies Ordinance.

23.4 We also **recommend** that any person with a mental disorder, as defined under the Mental Health Ordinance (Cap. 136), should be disqualified from acting as an insolvency practitioner.[317]

23.5 We note that section 168D, which makes general provision for orders for disqualification of directors, might need to be amended to take account of insolvency practitioners.

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[316] See Chapter 3 on the licensing of insolvency practitioners.

[317] "*Mental disorder*" is defined in the Mental Health Ordinance (Cap. 136), section 2, as "*mental illness, arrested or incomplete development of mind, psychopathic disorder or any other disorder or disability of mind*".

Where insolvency practitioner should not act as insolvency practitioner

23.6 As regards the submission that creditors, debtors and directors of a company should also be disqualified, we **recommend** that the regulations on insolvency practitioners should provide that a qualified insolvency practitioner should be disqualified from accepting an appointment where he is a creditor, debtor or director of a company, as it could constitute a conflict of interest.

23.7 The *Consultation Paper* proposed that anybody who had been an auditor of a company in the previous three years should be precluded from acting as an insolvency practitioner, as this also could constitute a conflict of interest. We understand that a prohibition from acting is already applied by the Hong Kong Society of Accountants' ethical guidelines.

23.8 We received a submission from the Hong Kong Society of Accountants drawing attention to the Society's:

> "... *Statement of Professional Ethics in respect of 'Integrity, Objectivity and Independence in Insolvency' which requires that where a practice has had a 'material professional relationship' with a company, no partner or employee of the practice should, inter alia, accept appointment as liquidator of the company if the company is insolvent. A 'material professional relationship' arises where a practice or a partner or employee of a practice is carrying out, or has during the previous two years carried out material professional work for that client. This includes where a practice or person has carried out, or has been appointed to carry out, audit work for a company. Where a company is solvent, such appointment should not be accepted without careful consideration being given to the implications of acceptance in that particular case, and a member of the Society should satisfy him or herself that the directors' declaration of solvency is likely to be substantiated by events.*
>
> *In one respect, the Sub-committee's [Consultation Paper's] proposal may not go far enough in that the 'group' situation has not been taken into account. The Society's Ethics Statement also provides that '... [a] material professional relationship with a company or individual includes any material professional relationship with companies or entities controlled by that company or individual or under common control where the relationship is material in the context of the company or individual to whom appointment is being sought or considered. A material professional relationship could also arise where a practice or person has carried out professional work for any director or shadow director of a company, of such a nature that a member's objectivity in carrying out a subsequent insolvency appointment in relation to that company could be or could reasonably be seen to be prejudiced'.*
>
> *While we would not necessarily propose going as far as this statement, which requires members of the Society to exercise a high degree of judgement, it would seem sensible to consider covering the basic holding company / subsidiary type of situation."*

23.9 We should add that the Securities and Futures Commission (SFC) submitted that the *Consultation Paper* proposal, that anyone who had been an auditor of a company within the three years prior to the liquidation should be precluded, by virtue of conflict of interest, from acting as an insolvency practitioner in that case did

not go far enough. The SFC considered that the persons precluded by conflict of interest from acting in the liquidation of a company should include any accountant who had, during the relevant period, a "*material professional relationship*" with the company, within the meaning of that term as it appeared in the *Code of Conduct for Accountants* issued by the Hong Kong Society of Accountants. The SFC concluded that this would serve to exclude accountants who had acted for the company as financial adviser, management consultant and persons who would clearly have, or be regarded as having, a conflict of interest.

23.10 The arguments put in the submissions are compelling. We **recommend** that appropriate provisions on material professional relationship should be applied to liquidators and to other office-holders where appropriate. We are not certain whether it would be more appropriate to place these provisions under this section or another section in the Companies Ordinance or whether they should form part of the regulations governing the licensing of insolvency practitioners. We prefer not to limit the recommendation to the Companies Ordinance and would rather leave consideration of this point to those who regulate the activities of office-holders.

Section 278A Corrupt inducement affecting appointment as liquidator

23.11 The section provides that anybody who pays or attempts to pay a creditor or member of the company to secure his own or some other person's nomination or appointment as liquidator shall be liable to a fine of $150,000.

23.12 We **recommend** that the provision should be expanded to include any form of appointment under the proposals on insolvency practitioners and to include forms of inducement other than a pure monetary inducement. In this regard, the words "*any corrupt inducement*" might replace "*any valuable consideration*".[318]

Section 283 Disposal of books and papers of company

23.13 The section provides that when a company has been wound-up and is about to be dissolved, the books and papers of the company and of the liquidators may be disposed of as follows:

(a) in the case of a winding-up by the court, in such way as the court directs;

(b) in the case of a members' (solvent) voluntary winding-up, in such way as the company by special resolution directs; and

(c) in the case of a creditors' (insolvent) voluntary winding-up, in such way as the committee of inspection or, if there is no such committee, as the creditors of the company, may direct.

318 Note the recommendations on the licensing of insolvency practitioners under Chapter 3.

23.14 Sub-section (2) provides that after five years from the dissolution of the company no responsibility shall rest on the company, the liquidators, or any person to whom the custody of the books and papers has been committed, by reason of any book or paper not being forthcoming to any person claiming to be interested in them.

23.15 Under sub-section (3), provision may be made by general rules for enabling the Official Receiver to prevent, for not more than five years from the dissolution of the company, the destruction of the books and papers of a company which has been wound-up, and for enabling any creditor or contributory of the company to make representations to him, and to appeal to the court from any direction which may be given by him in the matter.[319] The penalty for contravention of section 283 is level three, a fine of $10,000.

23.16 There are considerable problems in the practical application of the section. The Hong Kong Society of Accountants submitted that:

> *"Not all companies that go into receivership can be revived and put back to the control of its directors, or put into liquidation. In these situations, when the receiver ceases to act, the company is effectively abandoned as most, if not all, of the directors will have resigned or become uncontactable by then. Further, the fact that there will be no one to pass the company's books and records to might delay the ceasing to act of the receiver.*
>
> *Provisions should therefore be made to deal with these situations for 'automatic' liquidation or strike off of these companies. Section 283 of the Ordinance dealing with disposal of books and papers of a company which has been wound-up, may need to be amended to deal with the disposal of the company's records in these situations."*

23.17 The Hong Kong Institute of Company Secretaries submitted that:

> *"According to the Inland Revenue Ordinance, a liquidator must keep the books of a company for seven years while Companies Ordinance prescribes five years. However, members of a company can authorise the liquidators to dispose the company's books at any time they appoint by passing a special resolution under section 283(1)(a). Consistency would be desirable."*

23.18 The issues addressed below all revolve around the expense of storing the books of a company. Practitioners advise that it is or was common for receivers to find that after a receivership is completed there is no one left to hand the books of the company back to. This means that the receiver is obliged to store the books under section 121(3A) and this can be expensive.

23.19 Section 283 only provides for the preservation of the books of a company which is dissolved, sub-section (2) providing that the books should be retained for five years. Section 121(3A), however, provides that any books of account which a company is required to keep shall be preserved by it for seven years from the end of the financial year of which the last entry was made.

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319 Note that the Companies (Winding-up) Rules, rule 190, is relevant.

Commissioner of Inland Revenue

23.20 The concern for liquidators and receivers is that they cannot dispose of the books of a company as they may be obliged to make them available to the Commissioner of Inland Revenue for up to seven years.

23.21 The Commissioner was asked, for the purposes of the *Consultation Paper*, about the relationship between the Companies Ordinance provisions and the Inland Revenue Ordinance (Cap. 112), section 51(C), which provided that records should be retained for not less than seven years after the completion of the transactions, acts or operations to which they related. The *Consultation Paper* noted that sub-section (2) provided an exception to sub-section (1) where the Commissioner specified that records needed not be preserved or where a corporation had been dissolved.

23.22 The Commissioner advised that although in most cases he was not interested in dissolved corporations as their tax liabilities would have already been cleared, in the rare cases where a liquidator had dissolved a company which had outstanding or potential tax liabilities, the Commissioner had the right to reinstate the dissolved corporation under section 290 of the Companies Ordinance. The effect of this is that the discretion in the Commissioner to specify the records which need not be reserved under section 51C(2) would not give a liquidator or receiver much reassurance and he would still need to preserve the records in case the company is reinstated under section 290 of the Companies Ordinance. In addition, the Commissioner, as an aggrieved creditor, can move to have a company restored under section 290A(6) or under section 291(7).

23.23 On reinstatement, the company would be regarded as having not been dissolved and section 51C(1) of the Inland Revenue Ordinance would continue to apply to it. The Commissioner considered that it was necessary to preserve the record-keeping provisions, that was, section 283(2) in respect of dissolution, and section 121(3A) in respect of functioning companies, including companies that were in receivership.

23.24 It was the view of the Commissioner that any amendment to section 283 would not absolve an obligation which arose under section 51C of the Inland Revenue Ordinance.

23.25 The *Consultation Paper* commented that there was little that could be done on the question of the preservation of the records of a company under section 121 as that section was not part of the winding-up provisions of the Companies Ordinance and was not within the terms of reference; nor was section 51C of the Inland Revenue Ordinance.

23.26 We find, however, that section 283 is a confusing piece of legislation and should be made clearer. As we understand it, the effect of sub-section (1) is that a liquidator can dispose of the records of a company after about six months after dissolution in any form of winding-up, the six month period relating to a three months period for the dissolution of a company and a further three months for the final meeting of creditors.

23.27 Sub-section (2), however, imposes a five-year period under which the liquidator, the company or any person to whom custody of the books has been committed must retain the books on the off chance that someone might be interested in them. The only person, in all probability, who has sufficient authority to oblige liquidators to retain books under these circumstances would be the Commissioner of Inland Revenue, unless the Official Receiver uses his powers under sub-section (3).

23.28 The *Consultation Paper* proposed that there should be an automatic right in voluntary winding-up cases for the liquidator to destroy books six months after dissolution subject to an objection by the Official Receiver. If that were to happen we believe that sub-section (2) could be deleted.

23.29 We received a submission from the Commissioner of Inland Revenue which pointed out that the proposal appeared to be inconsistent with section 290, a point that we acknowledge. The Commissioner added that he could live with the proposal provided the proposal on tax clearance under section 239 was implemented.[320]

23.30 We trust that the introduction of a statutory procedure for the winding-up of solvent companies will facilitate easier application of this section. We would amend the original proposal to **recommend** that a liquidator should be able to destroy books two years after the dissolution of a company provided a tax clearance certificate had been obtained, otherwise a liquidator would be obliged to store the books and records for five years after dissolution. A statutory duty should be imposed on a liquidator to apply for a tax clearance certificate but it should not be necessary for him to have received the certificate in order to destroy the books two years after dissolution.

Costs

23.31 We consider it reasonable, and therefore **recommend**, that any person who applies to the court or the Official Receiver to have books preserved under sub-section (3) should be obliged to pay the costs of storage of the books for the term of the order.

Section 284 Information as to pending liquidations

23.32 This section requires that, in all liquidations, if the winding-up is not completed within a year, the liquidator shall send a statement to the Registrar of Companies with details of the proceedings in and the position of the liquidation.[321] Subsequent statements must be sent to the Registrar every six months.[322] The statement is open to inspection by creditors and contributories.[323] Liquidators who fail to comply with the section are subject to a fine of up to $10,000 plus a daily default fine of $700.[324]

320 See paragraphs 17.32 to 17.36.
321 Sub-section (1).
322 Companies (Winding-up) Rules, rules 181 and 182.
323 Sub-section (2).
324 Sub-sections (2) and (3).

23.33 In practice, the section applies only to voluntary windings-up, with section 203 fulfilling the same role for winding-up by the court. The *Consultation Paper* proposed that it should be moved to the provisions applicable to voluntary winding-up.

23.34 The Registrar had strong reservations regarding the current policy on section 284 under which accounts relating to insolvent windings-up did not need to be filed with the Registry. Although such accounts have to be filed with the Official Receiver and the court under section 203(6)(a), they can be inspected only by "*any creditor or any person having an interest*". Given the importance of transparency in maintaining Hong Kong's reputation as a major international financial and business centre and the practical reality of a number of recent high profile liquidations, the Registrar considered it essential, as a matter of public policy, that the accounts relating to all kinds of liquidations be filed with the Registrar of Companies. Consequently, the Registrar submitted that he would resist any attempt to move section 284 to the provisions applicable to voluntary winding-up.

23.35 The Registrar of Companies raised two issues; on the filing of accounts by companies being wound-up by the court and on any person having the right to inspect the statement of a liquidator.

Filing of accounts by companies being wound-up by the court[325]

23.36 The Official Receiver acknowledged that it had not been his practice to file accounts with the Registrar of Companies. This practice could be traced back to a policy decision made when the Official Receiver's Office and the Companies Registry formed two divisions of the now defunct Registrar General's Department. The Official Receiver's Office and the Companies Registry were now separate Departments and the Official Receiver acknowledged that it was appropriate that he should file accounts under section 284 with the Registrar of Companies.

23.37 The Official Receiver advised that the Official Receiver's Office had a difficulty with this as the Official Receiver's Office only prepared accounts on an accumulated basis and it would be very expensive for the Official Receiver's Office to change its computer system to make a six monthly return on the same basis as private sector liquidators. The Official Receiver asked for a dispensation to file accounts on an accumulated basis only under a new statutory form. We would agree to this request with the proviso that it would be desirable in the long term for the Official Receiver's Office to come into line with the accounting practices of private sector liquidators in this regard.

Any person should have the right to inspect the statement of a liquidator

23.38 The Registrar of Companies was not quite correct when he submitted that accounts filed with the Registrar were open to inspection without restriction. Sub-section (2) only provides for inspection of accounts by any person stating himself in writing to be a creditor or contributory of the company and this sub-section has been enforced by the Companies Registry. Section 203(6)(a) makes a similar provision.

[325] Note paragraphs 12.67 to 12.69.

23.39 We **recommend** that section 284(2) should be amended to provide that "*any person*" should be entitled to inspect the statement of a liquidator. The recommendation is made on the basis of the public interest as stated by the Registrar of Companies in his submission. Section 203(6)(a) should be amended in like manner.

Signing accounts by liquidators on conversion of liquidation

23.40 We refer to the recommendations on this point under section 203.[326]

Section 285 Unclaimed assets to be paid to Companies Liquidation Account

23.41 The section provides that if it appears that either from any statement sent to the Registrar under section 284 or otherwise that a liquidator has in his hands or under his control any money representing (i) unclaimed or (ii) undistributed assets of the company which have remained unclaimed or undistributed for six months after the date of their receipt, or any money held by the company in trust in respect of dividends or other sums due to any person as a member of the company, the liquidator shall forthwith pay the said money to the Companies Liquidation Account.

Public interest

23.42 Prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> "*In compulsory windings-up where there is an element of public interest, it is understandable that the funds under the control of the liquidator should be supervised and the requirement for payment of funds into the Companies Liquidation Account serves that purpose. However, in creditors' voluntary winding-up and members' voluntary winding-up in particular, there is probably a much lesser public interest need to supervise funds under control of the liquidator. The requirement for such funds to be paid to the Companies Liquidation Account adds to the administrative costs, for example, liquidator's time in administering the funds and related fees payable to the Official Receiver, but without any apparent benefits to the members and creditors.*
>
> *We do not, however, appreciate fully the purpose of the Companies Liquidation Account and how it actually operates particularly in respect of voluntary winding-up, but would like to suggest that if appropriate, consideration could be given as to whether undistributed and unclaimed funds now required to be paid to the Companies Liquidation Account should be left instead to the supervision of members or, in a creditors' voluntary*

[326] See paragraph 12.71.

winding-up, to the committee of inspection or if there is no such committee, the creditors."

23.43 The Society's submission touches on several issues including that of the funding of the Official Receiver's Office, to which we refer elsewhere.[327] While there is always an argument for doing away with unnecessary regulation, in this case there are also good arguments for retaining the provisions relating to making payments in to the Companies Liquidation Account, even in the case of voluntary windings-up.

23.44 There have been cases of professionals entrusted with clients' money disappearing with that money. We consider that by providing for payments into the Companies Liquidation Account in all forms of winding-up an element of safety is introduced for creditors. Liquidators are also free of accusations that they have not invested estate money efficiently.

23.45 The only reasons for providing that the assets in a voluntary winding-up might be capable of exclusion from the Companies Liquidation Account are that the estate could earn more by investing the money itself and that the estates would not be subject to payment of the 1.5 per cent fee charged by the Official Receiver, which is a lesser amount than is applied in other jurisdictions.

23.46 It is, however, questionable that liquidators in a voluntary winding-up could obtain better overall income from assets. The Official Receiver has advised us that under what is known as the "*Pool Investment Scheme*"[328] the Official Receiver pools funds from various estates for investment collectively. Funds belonging to individual estates therefore lose their unique identity once they join the scheme.

23.47 The Official Receiver invests in fixed deposits, which are arranged so that one 12 months' deposit matures every week and one weekly deposit matures every day to meet possible cash requirements. The Official Receiver can rearrange the schedule as and when required.

23.48 The advantages to the system are that by placing money in long term fixed deposits, the Official Receiver is able to earn high interest rates and cash is always available at short notice to meet payment obligations. It is not necessary to wait for deposits of a particular estate to mature before funds become available for payment, nor is it necessary for each estate to place funds on short-term deposit in anticipation of payment. Each estate is able to maximise its interest returns, particularly smaller estates because they attract the higher interbank interest rate which attaches to deposits of over $500,000.

23.49 Estates of less than $100,000 cannot invest in the Pool Investment Scheme. In such estates all the interest earned accrues to the Government under section 294. Estates of $100,000 or more may opt in or out of the scheme. Liquidators and special managers participating in the scheme may request the Official Receiver to specify the amount of investment.

23.50 The scheme has the additional attraction that there is no prospect of estate moneys being lost by the negligence or dishonesty of a private sector liquidator. While we accept that the recommendations for the introduction of qualified

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[327] See Chapter 5.

[328] See section 295 of the Companies Ordinance.

insolvency practitioners[329] would reduce such risks even further, the scheme seems to be a sensible and well run operation.

23.51 The questions of the charge of 1.5 per cent on the interest earned, and other administrative charges when assets are realized, go more to the nature of the funding of the Official Receiver's Office and we address that issue elsewhere.[330]

Inconsistencies between section 285 and rule 183

23.52 In a submission prior to the publication of the *Consultation Paper* the Hong Kong Society of Accountants submitted that:

> *"There are apparent inconsistencies between section 285 and winding-up rule 183 as regards the timing, the amount of and the terminology used for unclaimed and undistributed assets to be paid to the Companies Liquidation Account.*
>
> *Section 285(1) provides that 'If it appears that either from any statement sent to the Registrar under section 284 'or otherwise' that a liquidator has in his hands or under his control any money representing unclaimed or undistributed assets of the company which have remained unclaimed or undistributed for six months after the date of their receipt, or any money held by the company in trust in respect of dividends or other sums due to any person as a member of the company, the liquidator shall 'forthwith' pay the said money to the Companies Liquidation Account, ...'*
>
> *This could mean that the liquidator is required to keep track of the receipts on a daily basis, and to pay into the Companies Liquidation Account any unclaimed or undistributed monies 'forthwith' on the day 'exactly six months after the day of receipt' of the funds in question. This would be administratively impossible.*
>
> *Rule 183 sets out the rules relating to payment of undistributed and unclaimed money into the Companies Liquidation Account. Rule 183(2), which applies only to a voluntary liquidation, expands on section 285(1) and sets out additional provisions for payment of money representing unclaimed or undistributed assets under the control of the liquidator into the Companies Liquidation Account. This rule states that, among other things, the amount to be paid into the Companies Liquidation Account shall be paid into the Companies Liquidation Account within 14 days from the date to which the 'statement of accounts' is brought down. This is clearly in contradiction with the 'forthwith' rule in section 285(1). In practice, the Official Receiver makes a request for payment under section 285(1) subsequent to the filing of a liquidator's return or six months after commencement of a voluntary liquidation.*

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329 See the recommendations on the licensing of insolvency practitioners in Chapter 3.
330 See Chapter 5.

Further, rule 183(2) sets the amount to be paid to the Companies Liquidation Account, which shall be the minimum balance of such money which the liquidator has had in his hands or under his control during the six months immediately preceding to the date to which the liquidator's statement of account (Form 92) is brought down, less such part (if any) that the Official Receiver may authorise him to retain for the immediate purpose of the liquidation.

In practice, the Official Receiver makes no reference to rule 183(2) when requesting payments to be paid to the Companies Liquidation Account and the amount to be paid in is effectively all undistributed assets unless the liquidator gives good reasons for any proposed retention of funds.

In practice, the Official Receiver asks that all funds, that is, the closing balance, be paid to the Companies Liquidation Account regardless and puts the onus on the liquidator to justify to the satisfaction of the Official Receiver the retention of any funds in the liquidation, before such funds can be retained by the liquidator.

It is suggested that the law be revised to eliminate the apparent discrepancies between section 285 and rule 183. Additionally, it would be useful for the Official Receiver to issue guidance notes on their practice."

23.53 We **recommend** that "*forthwith*" in section 285(1) should be replaced by "*within 14 days*". This would remove the discrepancy pointed out by the Hong Kong Society of Accountants. The Hong Kong Society of Accountants further submitted that the recommendation should, for practical reasons, allow for one month in which to pay moneys into the Companies Liquidation Account. We consider that the 14-day period should allow sufficient time for liquidators to make payments.

Need to distinguish and separate provisions for "unclaimed" and "undistributed" assets

23.54 Both section 285 and rule 183 make provision for unclaimed and undistributed assets to be paid into the Companies Liquidation Account. Unclaimed assets (or unclaimed dividends) are different from undistributed assets in that unclaimed assets are assets which have been declared for dividend purposes but which have not been claimed by the creditors entitled to them whereas undistributed assets are assets that have been brought into the estate but in respect of which no dividend has been declared.

23.55 In practice, if assets remain unclaimed for a period of five years they shall, under section 285(5), be paid into the general revenue of the Government. If the person entitled to the unclaimed assets subsequently claims the assets, it is the practice of the Official Receiver to authorise a payment to the claimant from the general revenue. No time limit is put on such payments. We are satisfied that this process works well and that no amendment is required other than to **recommend** that the provision on unclaimed assets is separated from the provision on undistributed assets.

23.56 We **recommend** that the Official Receiver should publish annually a list of unclaimed assets and those entitled to them and that the list should also be placed on the Official Receiver's Office homepage on the internet.[331]

Prescribed period

23.57 Prior to the publication of the *Consultation Paper*, the Hong Kong Society of Accountants submitted that:

> *"As regards the five year limit, it is proposed that section 285(5) be amended to say that the prescribed period should be six years, to correspond with the statutory limitation period of contractual debt. We further propose that the period should only begin to run from the date of declaration of final dividend."*

23.58 The *Consultation Paper* stated that there was no evidence that the five-year period caused any problems in practice. The *Consultation Paper* had no objection to the period being changed from five to six years but it did not understand the reasoning behind the submission as it appeared that the six-year limitation would not relate to contractual debt but to the time limit for fraud.

23.59 The Hong Kong Society of Accountants further submitted that it remained of the view that the statutory limitation period, of six years, in respect of contractual debt was relevant to this provision. We consider that the practice of making payments to the general revenue is, in practice, a form of *bona vacantia*, and as such, creditors can claim unclaimed assets long after the current five-year limit. We are prepared, however, to **recommend** that the period of five years referred to in section 285(3) and (5) should be amended to six years.[332]

Tax Clearance Certificates and Estate Duty Clearance Certificates

23.60 There is sometimes a delay in obtaining tax clearance certificates and estate duty clearance. When delays occur in members' (solvent) voluntary windings-up, liquidators are obliged to place money in the Companies Liquidation Account. It had been pointed out that this had the effect that the Government benefited from these deposits while it processed the clearance certificates. The Official Receiver had indicated that if the only outstanding matter was the tax clearance certificate or the estate duty clearance then, in a members' (solvent) voluntary winding-up, the Official Receiver would be prepared to allow liquidators to retain monies without having to deposit them in the Companies Liquidation Account.

Section 289 Affidavits, &c.

23.61 The section provides for the swearing of affidavits in Hong Kong and elsewhere. Under the recent Adaptation of Laws (Courts and Tribunals) Ordinance, the reference to "*in Hong Kong and Commonwealth*" in the title to the section has been repealed and from "*elsewhere within the Commonwealth*" to "*outside the Commonwealth*" has been substituted by "*in any jurisdiction before any court, judge*

[331] The Official Receiver's Office's Internet address is *http://www.info.gov.hk/oro*.

[332] See the Limitation Ordinance (Cap. 347), section 4.

or person authorised under the law of that jurisdiction to take and receive affidavits in that jurisdiction" .[333]

[333] See Ordinance No. 25 of 1998, section 2.

Chapter 24 - Provisions as to Dissolution

Section 290 Power of court to declare dissolution of company void[334]

24.1 The section provides that where a company has been dissolved,[335] the court may within two years of the dissolution, on the application of the liquidator or any interested party, order that the dissolution has been void. The court may extend the two-year time period provided there are exceptional reasons for doing so. The provision applies whether a company has been wound-up by the court, by a creditors' (insolvent) voluntary winding-up or a members' (solvent) voluntary winding-up.

24.2 The *Consultation Paper* considered whether the court needed to be involved in an application to reverse the dissolution of a company. The *Consultation Paper* considered that there was, however, a public interest element in reversing the dissolution of a company and, though the costs of reversing a dissolution could be considerable, an application would only be made for good reasons, and that costs were a necessary expense that had to be factored in.

24.3 The public interest element is particularly important in the case of a company which has been wound-up as a members' (solvent) voluntary winding-up, as the members effectively guide the liquidation as opposed to the creditors.

24.4 The *Consultation Paper* considered whether the provision should only apply to members' (solvent) voluntary winding-up, with the establishment of some other process, perhaps an application to the Registrar of Companies, as an alternative for the other forms of winding-up. No proposal was made in the *Consultation Paper* but comments were solicited.

24.5 The Registrar of Companies submitted that there did not appear to be any compelling reasons for amending the current wording of section 290. Another submission suggested that the easier it was for a company to be liquidated and dissolved by its members, then it should be correspondingly easier, if there were good reasons, for an interested party to reverse the dissolution in order for any necessary question to be determined.[336]

24.6 We consider, on balance, that there is no good reason for amending the current provisions. We do not accept the point made in the submission that if it becomes easier to dissolve it should become correspondingly easier to void a dissolution. Section 290 is not used all that often whereas the dissolution of

[334] Note generally sections 239 and 248 in Chapters 17 and 18.

[335] Dissolved under sections 226A, 227, 239 or 248.

[336] We note the recommendation of the *Review of the Hong Kong Companies Ordinance*, at paragraph 9.04, that within a limited time, for example, 120 days, a company should be able to revoke dissolution essentially in the same manner as it has been initiated.

companies is an everyday occurrence.[337] The reversal of a dissolution should only be made for good reasons and we consider that the power should remain vested in the court.

Section 290A Registrar may strike off company for failure to forward annual returns

24.7 The section provides that the Registrar of Companies may strike a company off the companies register if it fails to file an annual return for two consecutive years.

24.8 We have no comment to make on the section. Sub-section (6), however, provides that a company may be revived for up to 20 years after it has been struck off on payment to the Registrar of Companies of a revival fee of $20,000. We refer to the preference accorded to the revival fee in the recommendations under section 265.[338] We note that it is proposed in the Companies (Amendment) Bill 1999 to repeal this section.

Section 290B Bona vacantia

24.9 The section provides that, where a company is dissolved under section 290A, all property of the company immediately before its dissolution, apart from property held by the company on trust for any other person, shall be deemed to be *bona vacantia* and shall accordingly belong to the Government.

24.10 The section is limited to cases where a company has been dissolved. The principle of *bona vacantia* in all other circumstances is dealt with under section 292.

Limitation of four months in respect of claims

24.11 The *Consultation Paper* expressed concern about the provision in sub-section (2) that a claim under *bona vacantia* should be made within four months after dissolution. It seemed to the Insolvency Sub-committee that as many claims under *bona vacantia* are property related and often do not arise for years, it tended to defeat the purpose behind the principle of restitution of property held by the Government to its rightful owner.

24.12 Instead of extending the established right of claimants to apply at any time for restitution of property, the section appears to penalise claimants in the case of companies dissolved under section 290A. The *Consultation Paper* proposed, and we **recommend**, that section 292 should apply to all claims of *bona vacantia*, regardless of how a company was dissolved.

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[337] In the years 1996 to 1998 the Companies Registry recorded seven cases where court orders were made under section 290; six of them members' (solvent) voluntary winding-up cases and one a creditors' (insolvent) voluntary winding-up.

[338] See paragraphs 20.77 to 20.80.

24.13 The Registrar of Companies has advised that the provisions of sections 290A to 292A would be subject to considerable review in the context of the Registrar's proposals regarding the deregistration of defunct private companies. The Registrar acknowledged that the problem outlined in the *Consultation Paper* underlined one of the concerns about the existing provisions which not only duplicated each other but were also inconsistent. [339]

Section 292 Property of dissolved company to be bona vacantia

24.14 The section provides that where a company is dissolved otherwise than under section 290A, all property of the company immediately before its dissolution, apart from property held by the company on trust, shall be deemed to be *bona vacantia* and shall accordingly belong to the Government.

24.15 Although there is no legislation on the point, it is the convention that if property that has vested in the Government under *bona vacantia* is subsequently claimed by its rightful owner, the property will be returned to the owner.

Claims to property which have vested bona vacantia in the Government

24.16 Prior to the publication of the *Consultation Paper,* the Hong Kong Association of Banks submitted that:

> *"The law relating to bona vacantia may need review in the context of the change in sovereignty in July 1997. In brief, in certain circumstances property can vest in the Government when it is not claimed by any person. At present by convention the Government will on application grant back property vested in it as bona vacantia to the original owner. This is however discretionary and perhaps either this practice should be formalised or the whole concept of bona vacantia abolished so that property remains with its existing owner rather than vesting in the Government."*

24.17 There appears to be an argument that the prerogative might have lapsed after the change of sovereignty on 30 June 1997. Whether or not the argument is correct, we **recommend** that the opportunity might now be taken to formalise the convention into legislation to the effect that where the outstanding or surplus assets of a defunct company vest in the Government the Government should return property to any rightful owner who can establish a claim to the outstanding or surplus property.

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[339] It is noted that it is proposed in the Companies (Amendment) Bill 1999 to repeal this section. It is also proposed that section 290E should be repealed.

Chapter 25 - Receivers and Managers

Review of role of receivers and managers

25.1 The *Consultation Paper* considered that receivership was so closely related to the winding-up provisions that it ought to be reviewed at the same time as the winding-up provisions. A number of submissions addressed matters of relevance and we comment on these below.

Combining Part III (Registration of Charges) and Part VI (Receivers and Managers)

25.2 Prior to the publication of the *Consultation Paper,* a submission suggested that it would be helpful to combine the current Part VI (Receivers and Managers) with Part III (Registration of Charges) so that, even without any further amendment, the law governing receiverships might be found all in one place within the Ordinance. The *Consultation Paper* agreed with the submission and proposed that Parts III and VI should be combined as they were closely related and that the combined provisions should appear before the provisions on the winding-up of companies.

25.3 The Registrar of Companies submitted that the conceptual logic of combining Part III, which was administered by the Registrar, with Part VI which would then be included in a new Insolvency Ordinance, was not understood. The Registrar considered that there was very little argument to justify why this should be done other than a reference to the assertion that the law governing receiverships would be found all in one place within the Ordinance. Conversely, it would cause confusion to those involved in registering the large numbers of company charges if the law on company charges were to be located in the Insolvency Ordinance, as opposed to the Companies Ordinance. The Registrar stated that, furthermore, receivers might be appointed by the court, for example, to hold the reins of power in a solvent company which was in a state of deadlock because of the entrenched positions of opposing shareholders and directors.

25.4 Notwithstanding the Registrar of Companies' remarks, we **recommend** that the two Parts should be combined for the reasons stated.

Regulation of insolvency practitioners

25.5 We refer to the recommendations for the regulation of receivers and other office holders under the insolvency regime under the recommendations for the licensing of insolvency practitioners.[340]

Certification of the appointment of a receiver or receiver and manager

[340] See Chapter 3.

25.6 Prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *"As the concept of a receiver or receivership is not found in most non-common law jurisdictions, practitioners have invariably been asked to explain and to prove, when dealing with parties in such jurisdictions as the PRC and Macau, the position, authority and powers of a receiver. All that the receiver is able to produce at the moment is likely to be his appointment papers which are invariably engrossed on plain white paper, bearing the signature of some duly authorised officer of the debenture holder or appointing bank. These papers simply do not appeal to these parties in such jurisdictions. They expect to see some documents from the relevant authority or the court to 'authenticate' the appointment.*
>
> *It would therefore be helpful if provisions can be included in the Ordinance for say, the Registrar of Companies to issue, on an 'as required' basis, 'official' certificate confirming that the appointment of the receiver or receiver and manager has been duly registered with the Companies Registry. The 'certificate' will of course need to be so worded that the Registrar is not confirming the validity of the appointment."*

25.7 The *Consultation Paper* called for submissions on the point. The *Consultation Paper* received support in a number of submissions with one submission suggesting that a possible alternative might be a specially designed declaration in which the appointor or its representative declared that the relevant person had been appointed as receiver.

25.8 The Registrar of Companies, however, considered the idea redundant as a certified copy of the notice issued under section 305(2) of the Companies Ordinance sufficiently proved that such a notice had been registered with the Companies Registry.

25.9 Practitioners obviously consider that a certificate from the Registrar of Companies would be useful in certain circumstances and, accordingly, we **recommend** that the Registrar of Companies should be obliged to provide a certificate on request. The Registrar should be entitled to charge an appropriate fee for this service.

Section 297 Disqualification for appointment as receiver
Section 297A Disqualification of undischarged bankrupts

Disqualification of directors

25.10 We **recommend** that reference should be made under these provisions to cases where a person is disqualified from acting as a receiver under the provisions of Part IVA of the Companies Ordinance. Section 168D(1)(c), provides for

disqualification of "*unfit directors*"[341] from being a receiver, and section 168G(1)(b) provides for disqualification of a person as a receiver or manager of a company if he has been guilty of a fraud or any breach of trust.

Receiver should not be liquidator of the same company

25.11 Prior to the publication of the *Consultation Paper*, the Hong Kong Society of Accountants submitted that:

> "*Section 300A(5) of the Ordinance states that 'this section and section 300B, where the company is being wound-up, shall apply notwithstanding that the receiver or manager and the liquidator are the same person, but with any necessary modifications arising from that fact.' This section seems to suggest that for the same company, the receiver and the liquidator may be the same person. This does not seem to accord with the generally held view that the receiver may not be the liquidator of the same company.*
>
> *Paragraph 16 of the Supplement to the Society's Professional Ethics Statement 'Integrity, objectivity and independence in Insolvency' provides that 'Where a partner in or an employee of a practice is, or in the previous two years has been, receiver of any of the assets of a company, no partner in or employee of the practice should accept appointment as liquidator of the company in an insolvent liquidation.' This restriction does not apply where the appointment was sanctioned by the court.*[342]
>
> *We submit that section 300A(5) be amended to reflect the need for independence in the discharge of the liquidator's duties.*"

25.12 We received a submission which agreed with the submission except to the extent that it should not apply to a receiver appointed by the court before that person was appointed liquidator. The submission continued:

> "*The ethical guidelines, except to the extent that they are open to abuse, intend to avoid the situation where a private receiver then becomes a liquidator. This is for two reasons. Firstly, among other roles a liquidator has to review the acts and the remuneration of a receiver. This is plainly impossible objectively if he has also been the receiver. Secondly, the receiver acts for one, or possibly more than one, but certainly a finite number of, secured creditors. A liquidator acts for the creditors as a whole, including all of the unsecured creditors. He therefore, has an insurmountable conflict of interest if he acts first as a receiver and then as a liquidator. Neither of these problems arise for a court appointed receiver who becomes the liquidator and there are circumstances one can imagine where it would be extremely beneficial for the court appointed receiver, who already has a good knowledge of the business, to continue as a liquidator.*"

25.13 We agree and **recommend** that there should be a prohibition on a receiver over the assets of a company later acting as liquidator of the same company,

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341 See the Fifteenth Schedule to the Companies Ordinance.

342 Note also the comment on the Hong Kong Society of Accountants' *Ethics Statement* under section 278, at paragraph 23.8.

whether in a voluntary winding-up or in a winding-up by the court. It would be undesirable for a receiver to subsequently act as a liquidator as it could place the receiver / liquidator in a conflict of interest between his obligations to the person who appointed him as receiver and his obligations and duties as a liquidator.

25.14 A liquidator would be under a general duty to look into the actions of any receiver of assets of a company in liquidation and a receiver / liquidator of the same company would not do this. It would not be in the interests of creditors and contributories generally for a receiver of assets of a company to later wind-up the company.

25.15 We **recommend** additionally that the prohibition should extend to partners or employees of the same firm who acted as receiver of a company which subsequently went into liquidation.

25.16 We also **recommend** that the regulations on insolvency practitioners, when they are drawn up, should contain this prohibition.

Section 300 Power of court to fix remuneration on application of liquidator

25.17 We understand that there is no obligation on a receiver to provide a liquidator with information in order that the liquidator can examine whether a receiver's charges had been reasonable in the circumstances. The *Consultation Paper* was undecided on whether or not receivers should be obliged to reveal such information.

25.18 One view taken was that as banks usually appointed receivers, they were aware of the level of fees that were appropriate for a particular situation and in respect of a particular receiver. Another view was that appointments of receivers were often made by private companies who had no knowledge of what an appropriate level of charging was for receivers. The *Consultation Paper* considered that, in any event, there was a good argument for more openness, as, if receivers could withhold such information from liquidators, there was always a chance that some receivers would abuse the situation.

25.19 The *Consultation Paper* sought comments on whether an "*obligation of reasonableness*" should be imposed on receivers and whether liquidators' powers to investigate whether a reasonable amount had been charged in the circumstances of a case should be extended.

25.20 We refer to the recommendations on the establishment of a Panel which would have the power to review the fees of insolvency practitioners. The recommendations contemplate the Panel reviewing the fees of receivers when a case is referred to it.[343]

25.21 Submissions generally felt that a liquidator should not be expected to investigate where it would not be appropriate to do so, as, for example, where a debenture holder suffered a substantial shortfall in assets recovered as against the debt amount and where there was nothing left for ordinary creditors anyway. We take

[343] See Chapter 4.

the point that there are many cases where it would not be necessary for the fees of receivers to be investigated. One substantial submission pointed out that:

> " *Whilst it is true that in most circumstances banks will ensure that receivers' fees are proper and reasonable, the banks may take less care if they are to be repaid in full. In those circumstances the fees of the receiver are not likely to come under such close scrutiny by the bank since, in effect, it is not the bank's money paying the fees. However, there should be no need for future legislation, since the common law provides all that is needed.*
>
> *A receiver appointed under a mortgage has a duty to account for his fees (Jeffreys v. Dickson 1866 LR 1 Ch. App. 183). Comments in Gomba Holdings UK Limited v. Homan (1986 3 All ER 94) suggest that this extends to a receiver appointed under a floating charge.*
>
> *Further, a mixture of interpreting the contractual right of a chargee under a debenture to take from charged assets the costs of a receiver and the equitable duty of good faith of a mortgagee and receiver will mean that a receiver's fees must in any event not be unreasonable. (See Gomba Holdings Ltd. v. Minories-Finance Ltd. (No. 2) 1992 & All ER 588 at 601J to 602a where Scott L J said : ' It is difficult to contemplate that a mortgage deed would ever be construed as entitling a mortgagee to charge against the mortgaged property, or to require the mortgagor to pay, all costs, charges and expenses even if improperly or unreasonably incurred or improper or unreasonable in amount unless the mortgage deed had expressly in terms so provided. But if a mortgage deed did expressly so provide, the enforceability of such a provision would, in our opinion, be open to serious question on public policy grounds.')*
>
> *The risk of express legislative provisions to allow taxation or review of costs after a receivership is that it will be used as a matter of course. The end result of that is likely to be that more of the assets which should be used to pay creditors will go in the legal and other costs of taxation. It is probably better if a combination of market forces and proper regulation of the insolvency profession ensure high standards in this area. The legal remedies already exist for those few cases where the charges are manifestly unreasonable.*" [344]

25.22 We consider that there is no need to make further provision in the Companies Ordinance under this section on the remuneration of receivers. If the recommendations on the establishment of a Panel are adopted a liquidator can apply to the Panel for a review of a receiver' s fees.

Section 300A Provisions as to information where receiver or manager is appointed

[344] Submission of Cameron McKenna, Solicitors.

Section 300B Special provisions as to statement submitted to receiver

25.23 Section 300A provides that, on his appointment, a receiver or manager of the whole or substantially the whole of the property of a company shall give the company notice of his appointment. Within 14 days of the appointment of a receiver, the receiver must be provided with a statement of affairs of the company. A receiver is obliged to provide the court with a statement of receipts and payments for every 12 months period after his appointment, with a final statement to be provided within two months, in most cases, after a receiver has ceased to act.

25.24 Section 300B provides that the company's statement of affairs shall be sworn by affidavit and submitted by, in most cases, the officers or employees of the company and shall show the company's assets, debts and liabilities, details of its creditors and any securities held by creditors, as at the date of the receiver's appointment.

Information to be provided by receivers to creditors and other interested parties

25.25 At present, a receiver is only obliged to provide details of receipts and payments to the Registrar of Companies. A receiver owes no obligation to creditors and contributories to provide details of the progress of the receivership. Separately, a receiver will undoubtedly report in much greater detail to the person who appointed him as receiver.

25.26 The *Consultation Paper* proposed that receivers should provide reports to the creditors and contributories of a company as they had an interest in knowing the financial position of the company. The *Consultation Paper* also proposed that in the event that a receiver was appointed but the company was not subsequently wound-up, creditors and contributories should be able to obtain a copy of a receiver's latest report on request on payment of a receiver's reasonable expenses and that a receiver's report should be updated every 12 months if necessary.

25.27 The *Consultation Paper* also proposed that where a receiver was appointed and the company was subsequently wound-up, a receiver should file a "*Receiver's report*" with the Registrar of Companies within one month of an appointor having given notice of his entering into possession of property the subject of the receivership under section 87(2).

25.28 The *Consultation Paper* stated that provision might be made for the receiver's report in the Official Receiver's Administrative Scheme for reporting regulations. In the context of reporting by receivers generally, the *Consultation Paper* noted some dissatisfaction among practitioners with the amount of information that some receivers were prepared to give to creditors and others. The *Consultation Paper* suggested that the Official Receiver, in preparing the rules for the licensing of insolvency practitioners, should address the issue.

25.29 While we maintain the proposals and **recommend** their adoption, there is a need to expand on the proposals. Section 301 provides that after a receiver ceases to act as receiver he should file a statement of his receipts and payments with the Registrar of Companies. We would intend the receiver's report to contain

more detail than a bare account of receipts and payments. We note that under section 48 of the Insolvency Act an administrative receiver should file a report with the Registrar of Companies as to:

- the events leading to his appointment in so far as he is aware of them,
- the disposal of any property of the company and the carrying on by him of any business of the company,
- the amounts of principal and interest payable to the debenture holders by whom or on whose behalf he was appointed, and
- the amount likely to be available for the payment to other creditors.

25.30 Section 48 of the Insolvency Act also makes provision for making the report available to ordinary creditors and to a liquidator where the company subsequently goes into liquidation. We **recommend** that the provisions of section 48 of the Insolvency Act be adopted for the purposes of the receiver's report but that care should be taken to omit any provisions that should apply to administrative receivers only. We note, however, section 48(6) of the Insolvency Act, which provides that confidential information may be excluded from the report. This should be adopted as there may be times when a receiver sells assets to a purchaser who demands confidentiality.[345] `

25.31 We amend the original proposal that the receiver's report should be filed within one month to **recommend** that the report should be filed within three months of the time set out in paragraph 25.27.

345 See comment under section 203, at paragraph 12.70.

Chapter 26 - Winding-up of Unregistered Companies (Cross-border Insolvency)

26.1 The treatment of cross-border insolvency is especially important in Hong Kong because of Hong Kong's status as an international business and financial centre. A large proportion of companies listed in Hong Kong are registered abroad and a large and growing number of other companies, both private and public, are also registered outside Hong Kong. It is therefore imperative that cross-border insolvency provisions should be promulgated that are both comprehensible and functional. The present provisions have presented some difficulty in terms of comprehension but have proved to be sufficiently flexible to suggest that, while they need to be clarified, the underlying intentions do not need to be greatly altered.

26.2 We received a considerable response to the proposals in the *Consultation Paper*, reflecting the need for appropriate cross-border provisions. We have taken account of the submissions and the recommendations modify the proposals as a result. We maintain the main proposal; however, that of the adoption of provisions along the lines of section 304 of the U. S. Bankruptcy Code which would provide the court with guidelines to apply to an application from a foreign insolvency proceeding.

26.3 We note that there is some strong support for adoption of the UNCITRAL Model Law of Insolvency[346], which is referred to below, but we have been unable to find any jurisdiction which has adopted the Model Law and we are hesitant about recommending that Hong Kong, which is a relatively small jurisdiction, should pioneer the Model Law. We are aware that the Model Law was before the last session of the U. S. Congress but that it lapsed and will need to be reintroduced at the next session.

Section 326 Meaning of unregistered company

26.4 The section provides that for the purposes of Part X, "*unregistered company*" includes any partnership, whether limited or not, any association and any company, with the following exceptions:

(a) a company registered under the Companies Ordinances of 1865 and 1911 or under the present Companies Ordinance;

(b) a partnership, association or company which consists of less than eight members and is not formed or established outside Hong Kong;

346 "*UNCITRAL Model Law of Insolvency*": the United Nations Commission on International Trade Law Guide to Enactment of the UNCITRAL Model Law on Cross-border Insolvency.

(c) a partnership registered in Hong Kong under the Limited Partnerships Ordinance (Cap 37).

26.5 A recent amendment has added the provision that for the avoidance of doubt it is declared that "*unregistered company*" includes an oversea company which is certified under section 333(3) as being registered under Part XI.[347]

Section 327 Winding-up of unregistered companies

26.6 Subject to the provisions of Part X, any unregistered company may be wound-up under the Ordinance, and all provisions of the Ordinance with respect to winding-up shall apply to an unregistered company, with the exceptions and additions mentioned in this section. No unregistered company can be wound-up voluntarily under these provisions.

26.7 An unregistered company may only be wound-up under these circumstances:

(a) if the company is dissolved or has ceased carrying on business or is carrying on business only for the purpose of winding-up its affairs; or

(b) if the company is unable to pay its debts; or

(c) if the court is of the opinion that it is just and equitable that the company should be wound-up.

Section 327A Oversea companies may be wound-up although dissolved

26.8 The section provides that where a company incorporated outside Hong Kong which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong, it may be wound-up as an unregistered company under this Part, notwithstanding that it has been dissolved or otherwise ceased to exist as a company under or by virtue of the laws of the place of its incorporation.

26.9 The Companies Ordinance provisions relevant to the area of cross-border insolvency are undoubtedly thin. Cross-border insolvency is an area that is becoming increasingly important as companies become more internationalised, with significant numbers of companies operating in Hong Kong either being registered in other jurisdictions or being owned by or owning foreign companies.

26.10 There is a temptation to make recommendations for the introduction of legislation that would comprehensively provide for every situation envisaged at present. We do not, however, favour the introduction of comprehensive provisions as the current provisions, when considered together with common law developments, already cover many of the areas that need to be addressed. Where we make recommendations, they relate to weaknesses or gaps in the current provisions that could be usefully resolved through legislation. These are mainly technical matters

[347] Ordinance No. 3 of 1997, section 48.

that would make it easier, for instance, for foreign insolvency proceedings to have access to the Hong Kong court.

26.11 Comprehensive legislation can also result in an inflexible procedure which is not desirable in an area of law that is constantly developing. We prefer to make recommendations for a legislative framework that would leave considerable discretion in the hands of the court in order that the court would have the power to react to any given set of circumstances. An example of just such a situation may be found in the "*Irish Shipping*" case, where the court allowed a foreign representative to file a petition on behalf of a foreign company.[348]

26.12 The way in which the winding-up of foreign companies is dealt with under the Companies Ordinance is explained as follows:

> *"Section 176 of the Companies Ordinance provides the Hong Kong court with the jurisdiction to wind-up any 'company', which is defined in section 2 as a Hong Kong company.[349] Foreign companies are wound-up pursuant to provisions in Part X of the Companies Ordinance. A foreign company in Hong Kong is called an 'unregistered company'; it is also called an 'oversea company' if it has established a place of business in Hong Kong. Although a foreign company is generally not considered to be a 'company' as that term is defined in section 2 of the Ordinance, it may be deemed to be a 'company' to the extent provided by Part X of the Ordinance.*
>
> *…Part X of the Companies Ordinance, entitled 'Winding-up of unregistered companies' contains the relevant sections for winding-up foreign companies. Section 326 defines 'unregistered company' to include any partnership, limited partnership, and company, except for, ..[among other things] …, a company registered …under the Companies Ordinance.*
>
> *Section 327(1), in turn, provides that, subject to the provisions of Part X of the Companies Ordinance, any unregistered company may be wound-up under the Companies Ordinance. Under section 327(3), an unregistered company may be wound-up under the following circumstances:*
>
> *(a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purposes of winding-up its affairs;*
>
> *(b) if the company is unable to pay its debts;*
>
> *(c) if the court is of the opinion that it is just and equitable that the company be wound-up."*

26.13 The recent amendment to section 326[350] was introduced as a consequence of the decision of the court in the case of *Securities and Futures Commission v MKI Corporation*[351], which held that an "*oversea company*" might be

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348 *Re Irish Shipping Ltd.* [1985] HKLR 437.

349 Section 2 defines "*company*" as a "*company formed and registered under this Ordinance or an existing company*". An "*existing company*" is, in turn, defined as a company formed and registered under earlier Hong Kong Companies Ordinances.

350 See paragraph 26.5.

351 [1995] 2 HKC 79.

wound-up as an "*unregistered company*"; another example of the court exercising its discretion appropriately.

26.14 Most foreign companies in Hong Kong are wound-up under section 327 and, although a foreign company may be wound-up under section 327A, in practice the section is rarely used.

26.15 The objective of these recommendations is to achieve provisions which would have the effect of providing that:

(a) any company which does business in Hong Kong, whether or not it is a company which can be wound-up as defined under section 177 or an "*unregistered company*" or "*oversea company*" as defined in sections 326 and 327A respectively, may be wound-up by the Hong Kong court;

(b) foreign insolvency proceedings may be recognised in main proceedings without the need for the foreign insolvency practitioner to initiate main insolvency proceedings under the Companies Ordinance; and

(c) such recognition would be based on the principle of reciprocity.

26.16 These recommendations would involve Hong Kong participating to some degree in what has been described as the simplification and unification of transnational insolvency proceedings.[352] The comment continued:

> *"Under this approach, a primary insolvency proceeding, which is intended to resolve all claims against the debtor's estate world-wide, occurs in the jurisdiction in which the debtor is domiciled or where the debtor's principal place of business is located. A trustee is appointed in this primary proceeding. To collect the world-wide assets of the debtor and to seek the turnover of all such assets to the primary proceeding, the trustee travels abroad and commences ancillary proceedings in each country in which assets of the debtor are located.*
>
> *In each of these ancillary proceedings the court recognises and gives effect to the declaration of insolvency in the primary proceeding, provides assistance to the trustee or foreign representative, applies the substantive insolvency law to the country in which the primary proceeding is occurring, and orders the turnover of all local assets to the primary proceeding. Because the final adjudication in the primary proceeding is respected by all jurisdictions, all creditors world-wide must submit claims in the primary proceeding or be forever barred from pursuing their claims."*

26.17 Giving effect to that intention is another matter and, although the international insolvency community is moving in the direction of the universal approach, there is probably no jurisdiction which applies the principle entirely. This does not mean that Hong Kong should not now make efforts to move in that direction as to do so would facilitate the resolution of insolvency cases expeditiously and for the

[352] Charles D. Booth, "*The Transnational Aspects of Hong Kong Insolvency Law*", *Southwestern Journal of Law and Trade in the Americas,* Spring 1995, Volume 2, Number 1, page 5.

benefit of all concerned. Such provisions should also enhance Hong Kong's reputation as a place to do business.

Jurisdiction of the court

26.18 In order for a company to be wound-up under the provisions of the Companies Ordinance it must be established that Hong Kong is the appropriate jurisdiction in which a particular company should be wound-up.

26.19 While companies which are incorporated in Hong Kong obviously qualify to be wound-up by the court under section 176, the situation is not so clear with regard to companies which are registered in other jurisdictions.

26.20 It was submitted that except for section 327A's application to situations where a foreign company "*which has been carrying on business in Hong Kong ceases to carry on business in Hong Kong*" the Companies Ordinance was silent as to the jurisdictional connection that had to exist between a foreign company and Hong Kong to enable the foreign company to be wound-up in Hong Kong. The submission suggested that two independent jurisdictional tests, one based on the presence of assets and another based on the carrying on of business either directly or through an agent, should be adopted into legislation.[353]

26.21 The "*assets based*" test referred to is just one example of "*sufficient connection*", with carrying on business either directly or through an agent being another test.

26.22 We do not accept that it is appropriate to incorporate specific tests into the Companies Ordinance because, as stated above, this could have the effect of limiting the discretion of the court to certain criteria that might not be appropriate to a particular set of circumstances. We **recommend** that the Companies Ordinance should not set out the jurisdictional requirements needed to establish a connection as we prefer to leave this to the discretion of the court in any particular case.

26.23 We received two submissions which considered that it would be better to set out specific tests for jurisdictional requirements on the basis that a list would provide certainty. It was submitted that the discretion of the court could be maintained by providing a final basis along the lines of "*for any other reason as the Court thinks fit*". There is certainly merit in the submissions but we consider that the net effect would eventually be the same due to the catchall discretion suggested. In any event, if the list option is eventually adopted into legislation, we suggest that it be contained in a schedule to the Ordinance to facilitate amendments.

Recognition of foreign proceedings

26.24 The Companies Ordinance does not make provision for recognition of foreign liquidation proceedings. Recognition of foreign proceedings would allow a foreign liquidator to apply to the court in Hong Kong for recognition of the foreign insolvency proceeding and recognition by the court would mean that the Hong Kong insolvency proceedings would be commenced as ancillary proceedings to the foreign insolvency proceedings. At present, a foreign liquidator needs to start insolvency

353 Submission of Mr Charles Booth and Mr Philip Smart.

proceedings afresh even though insolvency proceedings are under way in another jurisdiction. This is an area where we consider that the legislation should provide guidance to the court.

26.25 The Insolvency Act 1986, section 426, provides that the courts of the United Kingdom will co-operate with courts of certain designated jurisdictions, including Hong Kong. This leads to something of an anomaly as Hong Kong does not reciprocate with the United Kingdom or any other jurisdiction through legislation. We do not favour the concept of a list of jurisdictions[354] which would automatically receive co-operation as we would prefer to leave it to the courts to decide whether a foreign proceeding should receive co-operation from the court.

26.26 It is more important to exercise great care and control over the recognition of foreign insolvency proceedings. A submission pointed out that many of those countries which the United Kingdom recognised had not enacted reciprocal provisions (including Hong Kong). We **recommend** that the policy underlying the enactment of any provisions recognising foreign insolvency proceedings should be predicated on the basis that the proceedings recognised are harmonious with our own procedures.

26.27 Using this approach, we **recommend** that consideration should be given to providing recognition on a bilateral basis. While it may well take a long time to achieve wide ranging recognition with other jurisdictions, we suggest that there is no advantage to Hong Kong in providing recognition to other jurisdictions on a unilateral basis. The pursuit of a bilateral recognition policy would mean that those jurisdictions that wanted mutual recognition with Hong Kong would need to have procedures that are harmonious with that of Hong Kong.

26.28 It is for these reasons that we favour the approach taken under section 304 of the United States Bankruptcy Code. Under this approach, the Hong Kong court would need to determine whether to allow a foreign representative to commence a proceeding ancillary to the foreign proceeding in the Hong Kong court. The foreign representative would initiate the application by filing a summary application with the court. In determining whether to grant relief, the court should be guided by what would best assure an economical and expeditious administration of the estate. The court could apply the criteria which is applied under section 304 of the Bankruptcy Code, as follows:

(a) just treatment of all holders of claims against or interests in an estate that is being administered,

(b) protection of claims holders in (Hong Kong) against prejudice and inconvenience in the processing of claims in such foreign proceeding,

(c) prevention of preferential or fraudulent dispositions of property of an estate,

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354 In this context, Hong Kong is in a unique position. The Hong Kong Special Administrative Region is now part of the Peoples' Republic of China (the PRC) but, under the concept of "*One country, Two systems*", Hong Kong retains a separate legal system. This means that while Hong Kong is part of the PRC, to all intents and purposes the rest of the PRC may be treated as a separate and distinct jurisdiction.

(d) distribution of proceeds of an estate substantially in accordance with the order prescribed by (the Companies Ordinance), and

(e) comity.[355]

26.29 We **recommend** the adoption of a provision along the lines of section 304 of the United States Bankruptcy Code as this would provide the court with guidelines to apply to any particular case while leaving the court to exercise its discretion in each application and satisfy the main requirement, as we see it, that Hong Kong interests receive fair treatment in a foreign proceeding. An appropriate amendment should also be made to the Bankruptcy Ordinance.

26.30 In making this recommendation we reluctantly acknowledge that universal harmony is not going to happen any time soon despite the UNCITRAL Model Law on Insolvency.

"Oversea" companies

26.31 The title to section 327A refers to "*oversea*" companies, which is, we believe, a legacy of legislative drafting that is not only curiously worded, but is plainly wrong in the physical sense as part of the territory of Hong Kong is on mainland Asia.

26.32 We **recommend** that the reference to "*oversea*" should be amended to reflect the fact that the legislation would relate to companies which are not Hong Kong companies, bearing in mind that companies incorporated in mainland China are not foreign. We suggest that it might be more appropriate to use wording such as "*non-Hong Kong Special Administrative Region incorporated companies*".[356]

26.33 We received a submission from the Registrar of Companies that the recommendation to amend the term "*oversea*" would have very significant implications throughout the Companies Ordinance, in particular Part XI, and add substantially to the work of the Law Draftsman. The Registrar also considered that the statement that "*companies incorporated in China are not foreign*" was not understood as such companies were "*oversea*" in the sense that they were not Hong Kong companies.

26.34 The Registrar accepted, however, that the term was anomalous and archaic but would not wish to amend it until and unless an acceptable alternative was to be found. This is the nub of the issue. The term "*oversea*" might be well understood by those in the know but that is just not good enough for legislation, which should be clear and precise. We do not mind how "*oversea*" companies are defined; we would just like to have a definition that can be understood without further investigation.

Whether Hong Kong courts should apply foreign law in ancillary proceedings

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[355] These criteria summarise section 304(c) of the U.S. Bankruptcy Code. The section also applies in personal bankruptcy in the United States.

[356] It is understood that the Government's legislative exercise on the adaptation of laws will address "*oversea*", perhaps by amending the definition to "*outside Hong Kong*".

26.35 The *Consultation Paper* considered whether the Hong Kong courts should be permitted to apply foreign law in ancillary liquidation proceedings but decided against making a proposal to this effect. The *Consultation Paper* noted that a provision of this nature was found under section 426(5) of the Insolvency Act and that the United Kingdom courts applied foreign provisions in appropriate cases.

26.36 The *Consultation Paper* considered that it would be inappropriate to adopt a provision of this nature in Hong Kong. Concern was expressed that Hong Kong was involved in so many multinational liquidations that the Hong Kong courts could be faced with a large number and variety of applications to apply foreign rules and that, in addition, Hong Kong insolvency practitioners would not have the practical experience to apply foreign rules.

26.37 We received three submissions, one of which stated that:

> *" ... the use of some foreign provisions in an insolvency can assist with the orderly administration of the estate. Hong Kong insolvency practitioners are often partners of large international practices, or would have easy access to advice from international practitioners and advisers. To suggest they would not have the skills to deal with foreign law provisions is not a little patronising.*
>
> *Furthermore, when courts direct the use of a foreign law provision, they usually monitor carefully or give detailed directions on how the law is to be applied. In cases such as the Maxwell Group insolvencies which involved companies incorporated in England coming under the bankruptcy jurisdiction of the U. S. courts, the English and U. S. courts jointly blessed a scheme for administering the companies which was based on both laws. The suggestion that there will be multiple applications to apply foreign law seems unlikely to come to pass. The courts would only entertain such an application based on sound reason, not merely because a foreign law suited one party.*
>
> *It is to be expected that Hong Kong lawyers and courts will be naturally inclined to apply Hong Kong law unless there is good reason not to do so. Hong Kong is a cosmopolitan, international trade and finance centre. In order to remain so, its laws must be seen not to be too inward looking and protectionist. A power allowing the courts to be flexible in cross-border insolvencies is one which, even if only needed infrequently, helps to reinforce the view of Hong Kong as a place to do business for international investors."*

26.38 We are persuaded by the force of the submissions received and would additionally note that the courts already apply foreign law in such questions as divorce, conflict of laws and comity of laws. We therefore **recommend** that the court should be able to apply foreign law in ancillary proceedings subject to the proviso that the court could exercise its discretion in each application and satisfy the requirement that Hong Kong interests receive fair treatment in a foreign proceeding.

UNCITRAL Model Law on Insolvency

26.39 We should refer to the United Nations Commission on International Trade Law (UNCITRAL) Model Law which has been promulgated to assist

jurisdictions to formulate a modern, harmonised and fair legislative framework to address more effectively instances of cross-border insolvency. The model provisions are intended to provide jurisdictions with the opportunity to adopt certain internationally accepted practices into their law.

26.40 The Model Law is being actively considered in various jurisdictions but UNCITRAL itself has not been able to confirm to us that the Model Law has been adopted in any jurisdiction. While we welcome an initiative that encourages harmonizing the laws of insolvency internationally, we consider, for the reasons set out above, that Hong Kong should not be the first to adopt the Model Law.

26.41 We **recommend**, however, that in re-drafting the Companies Ordinance provisions on cross-border insolvency, the Law Draftsman might consider the extensive definitions that have been developed in the Model Law.

26.42 We received two submissions which encouraged the introduction of the Model Law. The Hon. Mr. Justice Rogers submitted that adoption of the Model Law would be beneficial to Hong Kong in that with time it was likely that it would be adopted in a number of jurisdictions and the absence of its provisions in Hong Kong might unduly hamper Hong Kong persons seeking redress overseas. The submission concluded that the adoption of these provisions in neighbouring countries would undoubtedly be beneficial to Hong Kong' s business interests and that it would be very difficult to convince such countries to adopt them if Hong Kong did not.

26.43 We do not reject the Model Law. We are simply exercising caution and a watch and wait approach. When the Model Law is adopted by leading jurisdictions, that would be the time to consider adopting the Model Law in Hong Kong, but until that happens we consider that there is no benefit in being the first to adopt the Model Law.

Chapter 27 - Companies (Winding-up) Rules

Rule 22A Deposit by petitioner

27.1 Note the comments on this rule at Chapter 7, paragraphs 7.4 to 7.7.

Rule 23A Copies of documents filed in proceedings to be served on Official Receiver

27.2 Prior to the publication of the *Consultation Paper,* the Official Receiver' s Office submitted that the requirement to serve copies of all documents in connection with any proceedings on the Official Receiver should not apply to section 168A petitions. This resulted in a *Consultation Paper* proposal that there should be no need for documents in connection with petitions under section 168A to be served on the Official Receiver.

27.3 The Official Receiver's Office has now changed its view and submitted that where there was a prayer to wind-up a company in a miscellaneous proceeding, copies of all documents filed with the court should be served on the Official Receiver. We agree that this is the correct approach. There is therefore no need to amend the rule.

Rule 24 Advertisement of petition

27.4 The Legal Aid Department submitted that:

> *" Rule 24 should be amended to correspond with the Practice Direction given by the Chief Justice on 27th June 1989 that the reference to at least two Hong Kong newspapers for the advertisement of a winding-up petition should include publication once in English in an English language paper and once in Chinese in a Chinese language paper."*

27.5 Paragraph (a) of rule 24 makes no specific provision for publication to be in one English language and one Chinese language newspaper. We **recommend** that rule 24 should be amended to reflect the terms of the Practice Direction.

Rule 28 Appointment of provisional liquidator

27.6 The Hong Kong Society of Accountants submitted that:

> *" After the presentation of a winding-up petition, the court may appoint a provisional liquidator at any time before the making of a winding-up order. Although section 193 and rule 28 cover the appointment and powers of a provisional liquidator, there is no express provision*

relating to the procedural aspects of a court liquidation involving a provisional liquidator such as notification of appointment and notification that the company is in liquidation, powers, gazetting of notices, etc.

There have been experiences in the past where provisional liquidators encountered practical problems when trying to lodge notices with the Companies Registry or determine whether, and in what form, the provisional liquidator should advertise his appointment. Practically speaking, practitioners try and follow the winding-up provisions. However, these are inadequate.

We propose that the duties, powers and responsibilities of a provisional liquidator of a court liquidation should be defined to ensure consistencies with existing rules and presently unclear areas are specifically provided for by legislation."

27.7 We agree with the submission and **recommend** that the appointment of a provisional liquidator should be advertised and gazetted. Notice of appointment should also be filed with the Registrar of Companies, who has agreed that this should be the case. This could be achieved by following the relevant provisions on appointment of a liquidator. The appointment of a liquidator must be gazetted and advertised, with notice of appointment to be given to the Registrar of Companies.[357]

27.8 The Official Receiver's Office submitted that a provisional liquidator' s obligation to give security should be set out in the rules. We **recommend** that this should be provided for.

Rule 33 Substitution of creditor or contributory for withdrawing petitioner

Withdrawal of petition where it has not been advertised

27.9 The rule provides that where a petitioner (a) fails to advertise the petition within the appropriate time or (b) consents to withdrawal of the petition, or to allow it to be dismissed, or the hearing is adjourned, or the petitioner fails to appear in support of the petition, or (c) if appearing, does not apply for an order in the terms of the petition, the court may substitute as petitioner any willing creditor or contributory who in the opinion of the court would have the right to present a petition.

27.10 Apart from this provision, there is no formal means by which a petitioner can withdraw a petition. The practice is that where a petition has been advertised it must be dismissed in open court. We consider that, once advertised, a petition should only be withdrawn or dismissed at a public hearing of the court.[358]

27.11 Where the petition has not been advertised, the practice is that it may be withdrawn with the consent of the parties but there is no authority of which we are aware for this practice.

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[357] Companies (Winding-up) Rules, rule 45(5) and (6) and rule 46.

[358] See Practice Directions of the High Court, Practice Direction No. 3.4.

27.12 The position is clear under the Insolvency Act, which provides that if at least five days before the hearing of a petition, the petitioner on an *ex parte* application, satisfies the court that (a) the petition has not been advertised, and (b) no notices have been received by him with reference to the petition, and (c) the company consents to an order being made, the court may order that the petitioner has leave to withdraw the petition.[359] We **recommend** that this provision should be adopted in the Companies (Winding-up) Rules in order to provide certainty as to how to proceed in such a situation.

27.13 We additionally **recommend** that the consent of the Official Receiver to a petitioner's application to withdraw a petition should be obtained in such circumstances.

Rule 47 Security to satisfaction of Official Receiver

Rule 48 Failure to give or keep up security

27.14 We refer to the recommendations on security to be given by liquidators under section 195. The rules will need to be amended as a consequence of the recommendation.[360]

Rule 88 Interest

27.15 We received a submission from the Hong Kong Society of Accountants which stated that they:

> " *... understand from the 'Quartermaine case'* [361] *that a secured creditor is entitled to continue to charge and receive interest from income generated from an asset over which he has a charge, even after the commencement of a liquidation. With reference to the above principle, we are concerned that the law is not clear on how to deal with a claim from a secured creditor in relation to any shortfall after realization of the security subsequent to the commencement of the liquidation, where interest generated by the security has been retained by the creditor towards paying post-liquidation interest on the debt (presumably at the contractual rate). This is ignoring, for the time being, any difference between the income generated and the interest charged after commencement of the liquidation.*
>
> *There are two possible approaches to determining the admissible claim. These are: (a) a claim could be made for the difference between the proceeds generated from realization of the security and the amount due as principal and interest on the debt as at the liquidation date, regardless of any post-liquidation interest charges. Any post-liquidation income generated from the charged security would then be used to pay off post-liquidation contractual interest*

[359] Insolvency Act, rule 4.15.

[360] See paragraphs 12.28 to 12.31.

[361] *Re London, Windsor and Greenwich Hotels Company* [1892] 1 Ch 639.

charges; or (b) the admissible claim would be the difference between total cash inflow generated from the security (i.e. the proceeds from realization of the security and any post-liquidation income) and the amount due as principal and interest accrued as at the liquidation date. No post-liquidation interest charges would be paid, even if the security continued to generate income after the liquidation date. In view of the above, we would ask the sub-committee to consider the inclusion of provisions prescribing how a liquidator or receiver should deal with post-liquidation income generated from a security, in respect of a debt which is subject to interest chargeable at a contractual rate."

27.16 It was held in the *Quartermaine* case that a secured creditor of a company which was in liquidation, who had exhausted his security without satisfying his debt, was not entitled to apply the proceeds of the security in payment first of interest subsequent to the winding-up, then in reduction of principal, and to prove in the winding-up for the balance of the principal. His proof had to be limited to what was due for principal and interest at the commencement of the winding-up after deducting therefrom proceeds of sale or realization received in respect of the security. The secured creditor is entitled, however, to set off profits realized from the security since the winding-up against interest accrued during the same period. We consider that this states the position appropriately and **recommend** its adoption in the rule if the rule is not sufficiently clear on the point.

Rule 93 Notice to creditors to prove

27.17 We refer to the comments on this rule under section 217.[362]

Rule 123 Quorum

27.18 The rule provides that the quorum at a meeting of creditors should be three creditors entitled to vote or three contributories or all the creditors entitled to vote or all the contributories, if the number of creditors entitled to vote or the contributories, as the case may be, does not exceed three.

27.19 We **recommend** that, if there is no quorum of three at the first meeting of creditors, the meeting should be adjourned but that at any subsequent meeting one creditor should constitute a quorum even if it is known that there are more than three creditors. We do not see why the one or two creditors who attend a meeting of creditors should be denied the right to vote because other creditors have not attended.

27.20 We consider that conflicts are more likely to arise among contributories than among creditors. In addition, shares could also be in the name of nominees who would refuse to attend meetings because they have no mandate from their principals. In the light of these potential complexities we **recommend** that two contributories should be present to form a quorum at a meeting of contributories. This recommendation would follow the Insolvency Act.[363]

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362 See paragraphs 14.45 to 14.52.

363 Insolvency Act, rule 12.4A(2)(b).

Rule 125 Cases in which creditors may not vote

27.21 We received two submissions on this rule, which was not referred to in the *Consultation Paper*. Rule 125 specifies that a creditor shall not vote in respect of any unliquidated or contingent debt, or any debt the value of which is not ascertained, or on a debt secured by a current bill of exchange or promissory note.

27.22 The submissions made the point that although the rule itself appeared to be straightforward and clear, when applied in some windings-up, such as those of construction or shipping companies, it could create difficulties and prevent genuine creditors from voting. The submissions concluded that, as long as a creditor had a genuine claim and submitted a proper proof of debt, as required by rule 124, it was reasonable that he should be able to vote at the creditors' meeting.

27.23 We agree. We believe that the solution may be found in the Insolvency Rules, rule 4.67(3), which 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 and admits his proof for the purpose of entitlement to vote. We **recommend** the adoption of this rule together with a recommendation made in the Commission's *Report on Corporate Rescue and Insolvent Trading*, which observed that there was no sacred formula that would satisfy the aspirations of all parties when valuing claims and that any valuation put on an unliquidated claim for the purposes of voting by the chairman at a meeting should not be overturned by the court unless it was manifestly unreasonable.[364]

Rule 127 Creditor required to give up security

27.24 This rule was not referred to in the *Consultation Paper*. The rule provides that the Official Receiver or liquidator may, within 28 days after a proof estimating the value of a security has been used in voting at a meeting, require the creditor to give up the security for the benefit of the creditors generally on payment of the value so estimated with an addition of 20 per cent. The creditor may, before being required to give up the security, correct the valuation by a new proof and deduct the new value from the debt, but in that case the addition of 20 percent is not payable if the security is required to be given up.

27.25 A submission stated that the valuation of the security would be made as of the date of the proof, but that a value changed over time. The submission suggested that it would be fairer if the payment in respect of the security was made for the current market value of the secured property, to be determined, failing agreement, by an independent valuer as an expert. The valuer's fees might be shared equally between the creditor and the estate.

27.26 There is a good reason for providing a liquidator with the power to oblige a secured creditor to sell a security to the estate as this allows a liquidator to act to frustrate a secured creditor who refuses to deal with secured assets to the detriment of the company in liquidation and other creditors. Such a provision is

364 The *Report on Corporate Rescue and Insolvent Trading*, paragraphs 16.35 to 16.41.

particularly useful when a liquidator has a higher offer for the security than the value placed on the security by the creditor.

27.27 We agree with the submission, however, that the arbitrary 20 per cent formula is wrong. We note that rule 12 of the old Meetings of Creditors Rules was identical to rule 127. The rule was repealed when the Meetings of Creditors Rules were placed in the Bankruptcy Rules.[365]

27.28 The solution may be found in rules 4.97 to 4.99 of the Insolvency Rules, which we **recommend** should be adopted. These rules provide that a liquidator may redeem a security at the value put upon it in the proof of the creditor. A creditor would then have 21 days, or longer if the liquidator agrees, to exercise a right to re-value the security. In the event that a creditor re-values the security the liquidator may only redeem at the new value. The liquidator may, if dissatisfied with the value put on the security (that is, either the original value or the re-valuation), require any property comprised in the security to be offered for sale. Additionally, if a creditor who has valued his security subsequently realizes it, the net amount realized shall be substituted for the value previously put by the creditor on the security and that amount shall be treated in all respects as an amended valuation made by him.

Rule 154 Resignation of liquidator

27.29 Please note the comments on this rule under section 245.[366]

Rule 157 Special bank account

27.30 Prior to the publication of the *Consultation Paper,* the Official Receiver's Office submitted that:

> *"The requirements in rule 157(1) that where a liquidator is authorised to have a special bank account, every cheque should be countersigned by at least one member of the committee of inspection and by any other person appointed by the committee should be removed. Committees of inspection have shown considerable reluctance to be involved in cheque signing."*

27.31 We take the point made in the submission but we note that the requirement of a second signature on cheques means that a liquidator is not able to act with complete independence where the assets of the company are concerned.

27.32 We consider that if the recommendations for the introduction of licensing of insolvency practitioners are introduced, the higher standards that should result among liquidators should justify amending this rule to allow a liquidator to write out cheques without the need for a second signature.

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365 See L. N. 79 of 1998.

366 See paragraphs 18.23 to 18.25.

Rule 160 Investment of assets in securities, and realization of securities

27.33 We received a submission which noted that rule 160 had been changed in 1994 to enable liquidators to inform the Official Receiver to make or withdraw an investment from the Companies Liquidation Account or to transfer funds into or out of the Pool Investment Scheme. The Hong Kong Society of Accountants said that in practice the scope of the decision for making and withdrawing investments from the Companies Liquidation Account was limited to transfers between fixed deposit accounts and non-interest bearing accounts and normally it was the liquidator who decided when to invest, when to make withdrawals and who advised the committee of inspection accordingly. The submission suggested that the practice should be set out in the rule. We agree with the submission and **recommend** its adoption.

Rule 176 Costs and taxation

27.34 The Hong Kong Society of Accountants submitted that:

> *"Rule 176 requires all costs and disbursements incurred in a winding-up by the court to be taxed by the court. Whilst such a requirement is useful for preventing possible disputes and as a measure of control over costs, it is not considered necessary in cases where the costs have been approved by the committee of inspection or the creditors. This requirement seems to add to costs without any apparent benefit to the creditors.*
>
> *By comparison, the Insolvency Act, rule 7.34, provides that the liquidator may require the costs of any agent to be taxed, which in effect leaves the matter to the liquidator's discretion. The requirement for taxation will only be imposed if the committee of inspection resolves or the court orders that costs be taxed. Accordingly, it is suggested that rule 176 be revised along the same lines as Insolvency Act, rule 7.34."*

27.35 We agree with the submission for the reasons stated and **recommend** that it should be adopted.

Rule 179 Costs payable out of the assets

27.36 This rule provides that the assets of a company in a winding-up by the court remaining after payment of fees and expenses properly incurred in preserving, realizing or getting in assets, including where the company has previously commenced to be wound-up voluntarily such remuneration, costs, and expenses as the court may allow a liquidator appointed in such voluntary winding-up shall, subject to any order of the court, be liable to certain payments which are set out in order of priority in the rule.

27.37 We note that there is no priority provided for special managers appointed by private sector liquidators but that a special manager appointed by the

Official Receiver as liquidator receives a priority. We **recommend** that a special manager appointed by a private sector liquidator should receive the same priority as a special manager appointed by the Official Receiver as liquidator.

27.38 We also **recommend**, following a submission to that effect, that the rule could be better laid out, perhaps along the lines of rule 4.218 of the Insolvency Rules.

Rule 183 Payment of undistributed and unclaimed money into companies liquidation account

27.39 We refer to the comments on this rule under section 285.[367]

Rule 190 Disposal of books and papers

27.40 We refer to the comments relating to the rule under section 283.[368]

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367 See paragraphs 23.52 to 23.53.

368 See paragraphs 23.13 to 23.30.

Chapter 28 - Directors: Payment of Compensation

28.1 Prior to the publication of the *Consultation Paper,* we received a submission from the Securities and Futures Commission that:

> *"We believe that one should assess whether directors who had managed the company which ended in insolvency were at fault. If so, we believe they should be held liable for mismanagement. Part IVA of the Companies Ordinance provides for directors who are unfit and directors who are in insolvency situations to be disqualified. ... The sub-committee may wish to see how the new insolvency procedures can accommodate procedures for application for directors' disqualification. Secondly, we believe there should also be financial penalty and provisions for compensation in serious cases. The possibility of a claim by the company against directors for breach of fiduciary duties can also be emphasised."*

28.2 The *Consultation Paper* did not make any proposals under this heading but discussed the possibility of imposing obligations on directors to sign an annual statement as to a company's affairs and the possibility of obliging directors to obtain compensation insurance.

28.3 A number of submissions were received which generally, but not completely, supported the idea that directors might be obliged to obtain compensation insurance and might be liable to pay compensation.

Imposition of fines and penalties on directors

28.4 The *Consultation Paper* questioned whether the imposition of fines and penalties was the most effective means of punishing directors who did not carry out their functions and obligations in a diligent and honest manner. In this context, we are disheartened by the apparent lack of concern that the courts exhibit towards offences that directors are convicted of under section 274.

28.5 The *Consultation Paper* considered that the concerns of the Securities and Futures Commission had been addressed in the *Consultation Paper* with the proposals for the strengthening of the offence provisions of the Companies Ordinance, sections 271 to 277, but the Securities and Futures Commission begged to differ and we have recorded the Securities and Futures Commission' s thoughts on the present level of fines being imposed by the courts elsewhere.[369]

Shifting of burden of proof onto directors

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369 See paragraph 22.39 to 22.45.

28.6 The recommendation that the burden of proof may be shifted in relation to offences under section 271 may cause problems in introducing the recommendations into legislation if it is considered that there is a conflict with the Hong Kong Bill of Rights.[370] While we have no desire to dilute peoples' rights, the fact is that company directors soon become aware that their prospects of being held responsible for their actions are not as great as might otherwise be expected as evidenced by the level of fines that are being imposed by the courts.

28.7 We are concerned that some directors consciously exploit this weakness in the application of the provisions. The ineffective application of the sanctions currently available may operate as an inducement to some directors to exploit the situation and, in regard to small companies where the directors are also shareholders, to regard the protection of limited liability as a sanctuary from which they deal with others with an impunity that they could never have as private individuals.

28.8 Even the introduction of the new provisions on unfair preferences[371] is unlikely to frighten those directors with inclinations towards dishonesty. The provisions generally do not strike directly at a director's point of ultimate interest: his own assets.

28.9 The recommendations made below range beyond our terms of reference as they address matters that relate to how solvent companies are managed, to how directors should be obliged to act, and to how directors may be made personally liable to compensate victims for their financial wrong-doings. These are issues that are, however, of concern to the insolvency provisions as provisions that assist in the prevention of unnecessary insolvencies, particularly insolvencies that are caused by asset stripping, should go some way towards tempering the worst cases of abuse by company owners.

28.10 The concern is that insolvency is often the result of bad management and some of this bad management is dishonest in nature. Insolvency practitioners know that directors very often get away with dishonest actions because creditors are not prepared to invest the time and money in pursuing these directors. The result is that dishonest directors set up again under a new company name and repeat the same scams against different people. The provisions for the disqualification of directors could go some way towards helping to rid the corporate world of these directors but the current provisions need to be strengthened to achieve these goals.

Directors may be obliged to obtain compensation insurance

28.11 *The Consultancy Report on the Review of the Hong Kong Companies Ordinance* recommended that apart from a breach of fiduciary duty, companies should be able to purchase directors' and officers' insurance for any risks which the market was prepared to issue.[372] The Standing Committee on Company Law Reform in 1993 considered the question of allowing a company to purchase indemnity insurance for its auditor or any of its directors. The Standing Committee,

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[370] See paragraphs 22.16 to 22.22.

[371] Companies Ordinance, section 266B.

[372] *The Review of the Hong Kong Companies Ordinance*, paragraph 6.17.

commenting on section 165 of the Companies Ordinance, and noting that other jurisdictions such as Australia, Japan and the United Kingdom allowed companies to purchase indemnity insurance for its directors:

> " *... accepted that in today's business environment where the business and legal demands on directors and other officers of the company are heavy and complex, it was commercially right that companies should be able to purchase indemnity insurance for its directors and officers*." [373]

28.12 We agree with this comment. We **recommend** that consideration should be given to providing that all directors of companies should be obliged to take out personal insurance against compensation claims. The level of insurance would relate to the amount of assets managed by directors or to a ratio between the assets of a company set against its liabilities. We note that such a provision would go against section 165 of the Companies Ordinance, which provides for the avoidance of provisions in the articles of association or in contracts which would relieve officers of a company from liability in respect of any negligence, default, breach of duty or breach of trust.

28.13 This recommendation could have several consequences. Insurers would pitch the level of insurance depending on a director's record, with higher standards attracting lower premiums. A benefit would be that claimants would know that they were not facing an empty victory and would be assured of recovering compensation for loss in the event of a successful outcome. This would encourage aggrieved creditors to take on companies and directors directly and directors would not be able to hide behind a "*scorched earth*" policy if they ever wanted to do business in Hong Kong again. Without insurance, creditors might be put off making a claim against companies, as directors would have time to disguise their assets through, for example, the use of trusts.

28.14 This problem was referred to in the *Report on Corporate Rescue and Insolvent Trading* when, in the chapter on insolvent trading, the Commission recognized that some directors might not have sufficient assets to justify a claim against them for compensation for insolvent trading.[374]

28.15 It should be possible to make provision to oblige directors to maintain insurance by making them subject to a fine and / or disqualification and to oblige auditors to report annually on the level and adequacy of insurance. It might also be useful to provide that companies should be obliged to display their certificates of insurance or produce them on request to interested parties.

28.16 We suggest that, initially, an insurance requirement might be placed on directors of publicly listed companies and that consideration might later be given to extending the provision to the directors of all companies operating in Hong Kong. One problem with obliging insurance for all companies is that the provision would catch small, single purpose, companies such as companies set up by people to hold property but which do not trade. It is questionable that directors of such companies should be obliged to obtain insurance.

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[373] *Tenth Annual Report of the Standing Committee on Company Law Reform*, paragraph 4.

[374] *Report on Corporate Rescue and Insolvent Trading*, paragraph 19.76.

28.17 In addition, we would be concerned that a mandatory requirement for insurance could result in the charging of unnecessarily high premiums by insurance companies. There is always a danger that when something is mandatory those supplying the service have no real interest in competition and costs drift higher. This should be avoided.

28.18 Essentially, we **recommend** that consideration should be given to moving away from the imposition of penalties and imprisonment and to concentrate more on disclosure and the payment of compensation.[375]

Obligation on directors to sign an annual statement as to the company's affairs

28.19 The *Consultation Paper* considered whether it was worth imposing an obligation on directors to prepare and sign annually a statement as to a company's affairs, the statement being part of the statutory statement of directors which accompanied the audited accounts.

28.20 The Securities and Futures Commission doubted whether such a statement would, in the case of listed entities, add much to existing obligations of directors under chapter 3 and disclosure requirements under chapter 14 of the *Listing Rules*. The *Listing Rules* mandate disclosure of essential matters in listed companies' annual accounts. There are also requirements under the *Code of Best Practice for Directors*.

28.21 Another submission had difficulty in understanding what the (presumably unaudited) statement as to a company's affairs would provide that the directors' report and the annual audited accounts did not already provide. The Hong Kong Society of Accountants, however, considered that the suggestion was consistent with some of the recommendations made by the Society towards strengthening corporate governance by improving transparency. The Society stated that the content and effect of any such statement, however, would need to be given careful consideration. The suggestion that directors could be required to provide reasons as to why significant claims against their company were being contested, for example, was potentially controversial, as this might involve their revealing legal advice received, or commercially sensitive information, to competitors.

28.22 We do not make a recommendation on this question but we consider that it is worth recording the opinions expressed as the matter may be taken forward by some other bodies.

Trading while insolvent

28.23 We would also note that the *Consultation Paper* made no mention of the recommendations in the *Report on Corporate Rescue and Insolvent Trading*[376] that directors and senior management of companies which were liquidated should become subject to liability for losses suffered by the company during the time that the company traded while it was insolvent. We consider that the adoption of such

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[375] The *Review of the Hong Kong Companies Ordinance* has also made reference to the question of offences. See paragraphs 2.05 and 2.06 of the *Review*.

[376] See Chapter 19 of the *Report on Corporate Rescue and Insolvent Trading*.

provisions into legislation would go a long way towards satisfying the concerns of the Securities and Futures Commission.

Chapter 29 - Hong Kong Government Gazette – Advertising of Insolvency Related Issues

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29.1 A number of the winding-up provisions of the Companies Ordinance require the publication of notices in the Hong Kong Government Gazette. Strong views were expressed by the Insolvency Sub-committee that the costs of advertising statutory notices in the Gazette are too expensive.

29.2 The Government Printer has advised that fees for advertisements are, as a matter of policy, market related and that they do not relate to the cost of producing them. The Secretary for the Treasury reviews fees annually, taking into account the current levels of rates for advertising in major local newspapers and the rate of inflation.

29.3 We must question the basis on which the Government calculates the costs of advertising insolvency notices in the Gazette. The Gazette is not a privately published newspaper subject to competition from other publications; it is a statutory monopoly. In our view, it is questionable that basing the charges for advertising on the market rate should be the criterion for costing the Gazette. We do not know whether the Gazette makes a profit for the Government but the experience of the costs of advertising insolvency matters, if applied to other advertisements, would suggest that the Government does profit.

29.4 We would point out that insolvency notices published in the Gazette are only published to comply with statutory requirements. Insolvency practitioners have advised that when publishing notices in local newspapers it is a common practice to publish in the newspaper that offers the cheapest rates. This option is not available with notices in the Gazette.

29.5 We took the Gazette' s Public Notices, Supplement No. 6, for Friday, 25 April 1997, and catalogued the first 50 notices, starting on page PN3570 with notice number 1, in the matter of *Hon Nin Estates Limited* and ending with number 50, on page PN3584, in the matter of *Iris International Limited*. We suggested to the Government Printer that many of the notices related to the same matters and that it should be possible to list these notices under one heading and then simply note the name of the company concerned underneath with the relevant details.

29.6 Of these 50 notices, 10 can be listed as notices to creditors to send particulars of their debts to liquidators, 12 are notices of final meeting under section 239, and 19 are notices of appointment of a liquidator under section 253.

29.7 Taking section 253 as an example, it would appear, from form 28 of the Companies (Winding-up) Rules, that all that needs to be stated in the notice is the name of the company, the names and addresses of the liquidators, and the date of the resolution. This could be done in a few lines, rather than in the nearly one third of a page that is required at present.

29.8 To illustrate the point, we set out the details of the first three references to section 253 as they might appear in the Gazette:

" The Companies Ordinance (Cap 32)[377]
-
Notice of Appointment of Liquidators
-
Members' Voluntary Winding-up
Pursuant to section 253 (rule 46, form 28)
-
Companies Filing Notice under this Heading [378]
(General heading)
\- - - - -

Fook Shau Tong Enterprises Limited
Liquidator: Julie Christina Hume
Address: Flat F, 8th Floor, 132, Electric Road, Tin Hau, Hong Kong
Date of Special Resolution of the Company: 27th March, 1997
-
Sekin Transport International Limited
Liquidators: Joseph K.C. Lo and Dermot Agnew
Address: both of 26th Floor, Wing On Centre,
111, Connaught Road, Central, Hong Kong
Date of Special resolution of the Company: 14th April 1997
-
Lagash Company Limited
Liquidator: Lam King Shan
Address: Flat D, 5th Floor, Fu Dat Court,
32, Fortress Hill Road, North Point, Hong Kong
Date of Special resolution of the Company: 24th April 1997"

29.9 We put this example to the Government Printer who advised that the simplified version of notice could reduce the advertising fee by approximately 74 per cent. The Printer pointed out, however, that this figure did not take account of the cost of the standardised heading, but we would view this as a minor matter. We also note that if notices were grouped in sections and, within sections, alphabetically, it would make searches in the Gazette against particular companies much easier.

29.10 We do not suggest that the reduction of the size of notices in the sample is perfect or even entirely in compliance with the statutory requirements but we consider that large savings could be made if notices were standardised. We **recommend** that the Official Receiver in conjunction with the Law Society, the Hong Kong Society of Accountants and the Hong Kong Institute of Company Secretaries (those bodies which would make up the bulk of practitioners who would be licensed as insolvency practitioners), should form a working group to look into how the advertising of notices in the Gazette could be shortened. A suggestion that might be considered would be the introduction of forms of consolidated advertisements which could be placed in the Companies (Winding-up) Rules.

[377] The Companies Ordinance heading could appear at the top of every page instead of in every notice.

[378] The heading for each type of notice could appear just once, or at the top of every page, such as, " *Notice of Appointment of Liquidators (under section 253) (Continued)*" .

29.11 We also **recommend** that the Official Receiver, the Law Society, the Hong Kong Society of Accountants and the Hong Kong Institute of Company Secretaries should consider ways in which the content relating to the winding-up provisions in notices may be reduced in length and size for the purposes of advertisements that must be placed in newspapers.

Chapter 30 - Transfer of Business (Protection of Creditors) Ordinance

30.1 We have received three substantial submissions on the Transfer of Business (Protection of Creditors) Ordinance (Cap 49). While the general provisions of the Ordinance are not within our terms of reference, certain provisions of the Ordinance do have relevance to insolvency and thus come within the terms of reference.

30.2 Although many of the comments made in the submissions set out in the following paragraphs are not directly relevant to insolvency, the force of the submissions suggests that the Ordinance does not have the intended effect and needs to be re-examined. The experience of members of the Insolvency Sub-committee reflects the comments made in the submissions.

30.3 We consider that the Ordinance, if effectively drafted, would fulfil a useful function as it is not beyond the bounds of possibility that people could still attempt to transfer businesses without disclosing the true position of the business. The Ordinance should have the effect of providing that where there is dishonesty in the transfer of a business the Ordinance facilitates the pursuit of the vendors without the need to prove fraud against them.

30.4 The Hong Kong Society of Accountants submitted:

> *"The Transfer of Business (Protection of Creditors) Ordinance provides protection to unsecured creditors of a business on the transfer of that business by creating a liability in the hands of the transferee for all the debts incurred by the transferor in carrying on the business.*
>
> *While we recognise that there needs to be some sort of protection and recourse for the creditors when businesses are transferred, we have found the legislation to be quite unusable due to the lack of clarity in the provisions and absence of case law.*
>
> *We note that there is no similar legislation in Australia or in the United Kingdom and that the legislation is quite unique to Hong Kong. The legislation also appears to be quite in-operative. We cannot recall the law having ever been tested in court nor can we provide any relevant authoritative cases thereon. We surmise that due to the significant uncertainties contained in the legislation, most people would try to avoid using it.*
>
> *The following are some anomalies that we have identified in the legislation which may affect :*
>
> *(a) the liquidator in a voluntary liquidation.*
>
> *(b) the receiver or charge holder acting pursuant to a charge registered for less than one year.*

Section 10 of the Ordinance provides that ' This Ordinance shall not apply to any transferee where the transfer is effected:

(a) by the Official Receiver or a trustee in bankruptcy;

(b) by the liquidator of a company [in liquidation] other than voluntary liquidation;

(c) by the Financial Secretary Incorporated;

(d) by the Director of Education Incorporated;

(e) by the Director of Social Welfare Incorporated;

(f) by a person selling under or pursuant to a charge which has been registered for not less than 1 year at the date when the transfer takes effect;

(g) pursuant to any order or direction of any court;

(h) by an executor or administrator; or

(i) by operation of law.'

The words ' other than voluntary liquidation' in section 10(b), and ' for not less than 1 year' in section 10(f) should be deleted, as we cannot see why these limitations should be imposed, to create a potential liability for liquidators in voluntary liquidations and receivers."

30.5 The Hong Kong Institute of Company Secretaries noted two areas of concern when it submitted that:

" Given the uncertainty in the meaning of a transfer of business in the interpretation sections and otherwise, it is difficult to see how the Ordinance can effectively achieve the protection of creditors objective."

30.6 We refer to the submission of the Hong Kong Society of Accountants that liquidators in voluntary windings-up could be excluded by deletion of the words in section 10(b) of the Ordinance that " *other than voluntary liquidation*" and that the words in section 10(f) " *not less than 1 year at the date when the transfer takes effect*" would satisfy the needs of receivers and liquidators by excluding them from the effect of the provisions. We **recommend** that these provisions should be deleted from the Ordinance as we agree with the Society that there is no reason why these limitations should be imposed on liquidators in voluntary liquidation and receivers. The introduction of a regime of licensed insolvency practitioners would provide a further justification for the deletion of the provisions.

30.7 We note that one submission pointed out that the Ordinance would need to be considered in connection with provisional supervision if the recommendations on provisional supervision are brought to legislation.

Chapter 31 - Netting Systems

31.1 An example of a clearing house netting system in operation in Hong Kong is the Central Clearing and Settlement System (CCASS) operated by the Hong Kong Securities and Clearing Company Limited, which was established in 1992. Netting arrangements (that is, arrangements under which two parties or any number of parties enclose or ring-fence their dealings to the exclusion of all other parties) are likely to increase in number in the next few years.

31.2 Before the CCASS was introduced the Insolvency Sub-committee was consulted on the idea. The Insolvency Sub-committee was not in favour of it nor of any scheme which would have the effect of isolating some parties from the consequences of the insolvency of one of those parties as against the general body of creditors outside the settlement system. The Insolvency Sub-committee was concerned that it amounted to an exception to the principle of *pari passu* distribution and that the parties who operated in the system would have first bite at the assets of the insolvent party within the system.

31.3 In the case of the insolvency of one of the parties to a netting system, the system would operate to settle all the dealings between the insolvent party and all other parties. In the unlikely event that the insolvent party had a surplus within the system, the balance would be released to the estate of the company for the benefit of other creditors. In the event of a deficit after settlement, the other parties in the system would claim in the liquidation as ordinary creditors.

31.4 The CCASS, for instance, was introduced because it created an environment where settlement of accounts in relation to stock dealings could be completed much quicker than previously and it also facilitated the introduction of a "*paperless trading system*" as opposed to the previous practice of trading by share certificates.

31.5 The clash between the settlement system and insolvency was that, if the principle of *pari passu* distribution was to be applied to the insolvency of one of the parties to the settlement system, it would mean that all the dealings between the parties within the settlement period would have to be unravelled and that, given the number of dealings involved in the CCASS the task would be both monumental and expensive.

31.6 Electronic settlement systems are not limited to dealings in stocks and shares but are also used for foreign exchange dealings, derivative dealings, inter-group and inter-branch netting, global inter-branch netting (that is, the netting of contracts with different branches of the same counterparty in different countries) cross-product netting, cross-currency netting and special counterparties netting, for example, special rules for banks, insurance companies and statutory public bodies.

31.7 It has been represented to us that there were strong public policy arguments for the introduction of more settlement systems, all of which would provide for netting between the parties without being subject to the regular insolvency provisions in the first instance. It is suggested that it would be in the best interests of Hong Kong's development as a major financial centre for more clearing house systems to be introduced and that this would necessarily involve a system for netting in each case.

31.8 The principal reason for allowing netting is to limit systemic risk in payment systems and financial markets and to improve payment and settlement system efficiency by minimising settlement costs and reducing credit and liquidity exposures. It is also represented that netting enhances the implementation of policy objectives of central banks. The disadvantages of netting are that it can increase systemic risk as netting may obscure the level of exposure and it would concentrate risk exposure of the central counterparty for multilateral netting systems.

31.9 In insolvency terms, netting may operate against unsecured creditors in an insolvency situation, but lowering settlement risks may minimise insolvency risks in the first place. It is therefore pragmatic and sensible to consider how the insolvency provisions might need to be adapted to accommodate netting systems when insolvencies occur in those systems.

31.10 We understand that special netting statutes already exist in at least 12 jurisdictions, including the United Kingdom, Canada, Cayman Islands, Germany, Japan, Sweden and the United States. In the United Kingdom, Part VII of the Companies Act 1989 provides for insolvency in the financial markets by aiming to reduce the possibility of domino insolvencies by enhancing the effect of the practice used by the market of netting out exposures to defaulting counterparties and by protecting margins and security given to support the obligations of participants.

31.11 Part VII is applied to "*market contracts*" connected with "*investment exchanges*" and "*clearing houses*" provided that these institutions have "*default rules*". Under section 156 of the Companies Act 1989, the default rules provide for the steps to be taken by the exchange or clearing house to close out a defaulting participant's position in relation to all unsettled market contracts in the event of the participant appearing to be unable to meet its obligations.

31.12 The effect of Part VII is to establish the principle that all the losses and gains on a defaulting party's contracts are netted out to be reduced to a net sum which is either provable in its insolvency or payable to it. Part VII affects the insolvency provisions:

(a) to the extent of a liquidator's power to disclaim contracts and the ability of the court to rescind contracts, under section 164 of the Companies Act 1989;

(b) in relation to the rules avoiding post-petition disposals, also section 164;

(c) in relation to the rules avoiding preferences, transactions at an undervalue, and transactions defrauding creditors, under section 165; and

(d) in relation to the statutory freeze on proceedings after an insolvency, under section 161(4) of the Companies Act 1989.

31.13 The Securities and Futures (Clearing Houses) Ordinance (Cap. 420), contains provisions similar to those in Part VII of the Companies Act 1989. In particular, section 2 of the Ordinance defines "*market contract*" to mean the resultant contract between a "*recognised clearing house*" and a participant pursuant to a novation in accordance with its rules and for the purposes of clearing and settlement of securities or future contracts made on the Hong Kong Stock Exchange or the Hong Kong Futures Exchange. Section 5 of the Ordinance provides that the rules of a

recognised clearing house and any proceedings taken thereunder take precedence over the law of insolvency. This provision would take clearing and settlement of market contracts out of the ambit of insolvency law.[379]

31.14 There is no provision in the Companies Ordinance which takes account of the development of netting systems. While we are not entirely at ease with creating exceptions to the established insolvency regime, we consider that notice needs to be taken of these developments.

31.15 We received a submission from the Hong Kong Association of Banks which supported the *Consultation Paper* proposal, now recommendation, and which suggested that there were at least two main reasons why modern-day settlement systems based on netting had to be recognised as an exception to the application of traditional insolvency principles:

> " *(a) the impracticality, not to mention the expense, of reversing a large number of transactions which have already been processed and settled through the system based on netting (even the law must yield to commercial reality, and traditional insolvency principles were not developed to deal with such massive numbers of transactions);*
>
> *(b) the linkage or interdependence between numerous transactions (where a receipt on one transaction is expected to pay for another transaction) creates a greater risk that one or more of the other participants in the system may fail by reason of the failure of one participant, and hence a risk to the operation of the system itself. If the system is important to the economy, e.g., a 'national' payments or securities clearing system, then it is necessary to try to maintain the efficient working of the system at all times. Such risks do not exist among ordinary suppliers to a business.*"

31.16 Accordingly, we **recommend** that the insolvency provisions should take account of recognised netting systems and make provision for the effects of netting on a liquidation and, in particular, how the insolvency provisions would deal with the aftermath of a netting event.

379 Note also sections 8, 9, 11 and 14 of the Securities and Futures (Clearing Houses) Ordinance (Cap 420), which contain further provisions on insolvency issues.

Chapter 32 - Related Companies

32.1 Prior to the publication of the *Consultation Paper,* the Hong Kong Society of Accountants submitted that:

> *" The basic legal position when winding-up separate companies in a group is that each company is a separate legal entity and it is not possible to sacrifice the interest of any one company for the interest of the group.*
>
> *In practice, however, a group is often run as one business by a single management. Transactions within the group are not necessarily on a commercial basis. Effectively one subsidiary may be sacrificed for the good of the group. In such a situation, creditors of that subsidiary may be left without recourse to adequate assets to meet their claims.*
>
> *In such situations it may be equitable to consider consolidating group assets and liabilities so that there is a more equitable distribution. Such a pooling scheme would benefit creditors in that it would cut the costs of liquidating a large group of companies. Further, the problems associated with inter company accounts are eliminated.*
>
> *Safeguards would need to be put in place to ensure such provisions were only invoked if it were just and equitable to do so by the court.*
>
> *For reference to overseas practice, we understand that the New Zealand Companies Act 1955 (as amended) and the US Bankruptcy Law already allow such consolidation."*

32.2 We received a submission from the Hong Kong Association of Banks which supported the submission of the Hong Kong Society of Accountants and stated that:

> " *The manner of management of a group as pointed out by the Hong Kong Society of Accountants is a reality. It raises important issues as group companies are very common. While the ramifications go beyond the winding-up provisions, the issues insofar as they concern the liquidation of an insolvent company within a group are within the terms of reference. There is a real and pressing need for these issues to be addressed."*

32.3 We consider that the points made in the submissions have merit but we are concerned that the ramifications go far beyond the winding-up provisions of the Companies Ordinance and, as a consequence, our terms of reference. We suggest that this is an issue that would be more appropriately addressed by the Standing Committee on Company Law Reform.

Chapter 33 - Subordination of Debt

33.1 Prior to the publication of the *Consultation Paper,* the Hong Kong Association of Banks submitted that:

> *"At common law debt subordination is not possible because it has been held to infringe the principle of pari passu distribution among creditors. When parties wish to achieve a valid subordination under Hong Kong law this is achieved by a complex trust structure. Subordination of debt and the creation of debts of different levels of seniority is part of many modern security packages and this should not be inhibited by law. We suggest that the law be changed to allow for contractual subordination."*

33.2 The *Consultation Paper* proposed that the subordination of debt should be allowed so long as the subordination of debt agreement does not affect the rights of third parties.

33.3 We received a submission which stated that subordination of debt necessarily would affect the rights of third parties as that was what it sought to achieve. The submission stated that the proposal should be that the subordination of debt should be allowed so long as the subordination of debt agreement did not adversely affect the rights of third parties. We take the point and **recommend** its adoption accordingly. We note that a contractual subordination arrangement was upheld by the English High Court in a recent case[380].

33.4 We note that the Australian Corporations Law, section 563C, inserted in 1992, has confirmed contractual debt subordination so long as it does not prejudice a creditor who is not a party to the agreement.

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[380] *Re Maxwell Communications Corpn plc* [1993] 1 WLR 1402. Note also an Australian case, *United States Trust Co. of New York v. Australia & New Zealand Banking Group Ltd.* (1995) 37 NSWLR 131.

Annex

Acknowledgements

Association of Chartered Certified Accountants - Hong Kong Office

Association of Insolvency Officers

Beverage Manufacturers Association of Hong Kong

Mr Charles Booth, Department of Professional Legal Education, University of Hong Kong

Cameron McKenna

Chinese General Chamber of Commerce

Chinese Manufacturers' Association of Hong Kong

Commissioner of Inland Revenue

Consumer Council

Education and Manpower Bureau

Employees Compensation Assistance Fund Board

Employers' Federation of Hong Kong

Federation of Hong Kong & Kowloon Labour Unions

Federation of Hong Kong Industries

Hong Kong Association of Banks

Hong Kong Association of Property Management Companies

Hong Kong Bar Association

Hong Kong Coalition of Service Industries

Hong Kong Democratic Foundation

Hong Kong Federation of Insurers

Hong Kong Federation of Trade Unions

Hong Kong General Chamber of Commerce

Hong Kong Institute of Company Secretaries

Hong Kong Institute of Real Estate Administration

Hong Kong Monetary Authority (Banking Policy Department)

Hong Kong Police Force (Crime Wing)

Hong Kong Shamshuipo Industry & Commerce Association Ltd

Hong Kong Society of Accountants

Hong Kong Stockbrokers Association Ltd

Hong Kong Trade Development Council

Hong Kong Women Professionals & Entrepreneurs Association

Judiciary Administrator’ s Office

Labour Advisory Board

Law Society of Hong Kong

Legal Aid Department

LegCo Panel on Manpower

Nelson Wheeler Corporate Advisory Services Ltd

Office of the Commissioner of Insurance

Official Receiver’ s Office

Mrs J C Olivier, former counsel of Legal Aid Department

Protection of Wages on Insolvency Fund Board

Registrar of Companies

The Hon Mr Justice Rogers, JA

Secretary for Financial Services

Securities & Futures Commission

Mr Philip Smart, Department of Law, University of Hong Kong

Standing Committee on Company Law Reform

Trade and Industry Bureau