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Hong Kong Corporate Rescue regime: a marathon yet to finish

By Terry Kan, *Partner*

Introduction

Credit crunches and sudden economic downturns can quickly undermine businesses in difficult times, but some businesses may be able to survive short-term financial difficulties if an effective corporate rescue process is available. This article will take you through the corporate rescue practices established over the years in Hong Kong and explain why the marathon to establish a statutory corporate rescue procedure has yet to cross the finishing line.

Before the onset of the Asian Financial Crisis in 1998, the average number of winding-up orders made by the court in Hong Kong for the decade before 1998 was about 400. In 2003/2004, company collapses stood at the peak of over 1,200 after the outbreak of the SARs epidemic. In 2008/2009, company failures fell to about 550 cases after the collapse of Lehman Brothers. Winding-up orders made in 2012 dropped to around 300 cases.

One key factor which contributed to the rising number of corporate collapses after the financial crisis was the lack of a corporate rescue regime in Hong Kong. The Companies Ordinance (Cap 32) (**CO**) and its subsidiary legislation provides comprehensive rules to deal with solvent and insolvent liquidations for both registered and unregistered companies. However, there is a lack of modern legal framework designed to save troubled companies from the fate of liquidation and, at the same time, balance the interests of creditors.

Corporate rescue - the Hong Kong approach

Traditionally, any default of payments on loans or failure to serve interest on debts by companies has triggered lenders, in particular bank creditors, to protect their interests by imposing an immediate suspension or termination of all financial support. Since the debtor companies are already struggling on extremely tight cash flow positions, few businesses survive this termination of credit.

The high number of company failures resulting from these arrangements triggered concern among major bank creditors to find alternative solutions to prevent debt-ridden companies

from sinking in this way – thereby preserving business value for a better return to creditors. Quite often, informal meetings among key creditors were called at short notice aiming to highlight key problems and bring in experienced restructuring and insolvency specialists for an urgent corporate health check and to recommend solutions to the debtor company.

In the absence of fraud or criminal allegations, this positive move in many instances safeguarded viable business as well as jobs for employees through a successful corporate rescue. This practice was widely adopted in many corporate work-outs and eventually resulted in the publication of a corporate rescue guideline, namely *Hong Kong Approach to Corporate Difficulties*, jointly issued by the Hong Kong Monetary Authority and the Hong Kong Association of Bankers in late 1999 which standardised the best practices at that time.

Essentially, the *Hong Kong Approach to Corporate Difficulties* promoted a supportive initiative led by bank creditors to maintain liquidity support to the borrower until well-informed decisions could be made to determine its prospects collectively by the bank creditors involved. Key to the success of this approach was the allowance of some breathing space on a consensus basis at the early stage, which prevented a financial crisis or a complete meltdown of the debtor company.

However, the *Hong Kong Approach to Corporate Difficulties* was only a voluntary and non-binding process. Other creditors, having diverse rights and interests, sometimes felt that their concerns were not considered at the outset and they were not even notified of the initial meetings. At best, these creditors pushed for separate meetings with the company in distress, but at worst, they petitioned for a court winding-up procedure to protect their interests.

Employees, typically with a mixture of preferential and unsecured claims, often find it unattractive to prolong their suffering by allowing time to proceed with corporate restructuring. Employees can apply for *ex-gratia* payments from the Protection of Wages on Insolvency Fund, which quickly alleviates their immediate financial needs. These payments are triggered upon the filing of a winding-up petition, rather than the discretionary process assessed on merit for companies undergoing restructuring where no liquidation proceedings have commenced.

Appointment of provisional liquidators and schemes of arrangement

This 'tug of war' between creditors trying to protect their interests is certainly unhelpful where companies are fighting to stay afloat. Over the last decade or more, the appointment of provisional liquidators through a court application (Section 193 of the old CO) by debtors or creditors was well regarded as a practical solution, pursuant to which a moratorium to stay legal proceedings was achieved automatically by operation of law unless with leave of the court (Section 186). This mechanism was complementary with the procedures set out in the *Hong Kong Approach to Corporate Difficulties* in most if not all restructuring attempts.

A typical Hong Kong corporate restructuring process therefore begins with the searching for a white knight investor and ends up with a rescue proposal through a scheme of arrangement (Section 166). Approval of a scheme of arrangement requires a majority in the number of creditors voting in favour of the proposal and they must represent at least three quarters of the value in question. A scheme of arrangement sanctioned by the court will bind other creditors holding opposite views to the scheme.

Restructuring through a scheme of arrangement has become a practical tool for the corporate rescue of large-scale or listed companies but it is rarely used for an SME as it can be complex and costly. Contractual

debt rescheduling or composition have also been used to rescue troubled businesses but the absence of a moratorium on debt demands remains a major obstacle.

Establishing a statutory corporate rescue procedure

'Provisional supervision' was first recommended as a corporate rescue procedure in the 1996 Law Reform Commission Corporate Rescue and Insolvent Trading report. Provisional supervision provides for a moratorium on debt demands for companies in corporate rescue. In 2000 and 2001, bills were proposed to the Legislative Council but the proposed law on provisional supervision was not enacted mainly due to the diversity of views regarding the treatment of employee entitlements.

The bills proposed either a full payment of all employee claims before the commencement of a provisional supervision, or a trust account to be set up in advance with money sufficient to fully pay all employee debts. It is not difficult to understand why this proposal did not appeal to investors. For companies which are either labour-intensive or employ high-ranking professionals selling financial products or services, employment debts could be significant. Investors are generally reluctant to provide funding solely for payment to employees and would rather ease the cash flow needs of the troubled organisation to maintain operations during the restructuring.

A further public consultation on a statutory corporate rescue procedure was launched in late 2009 and concluded in July 2010. The focus was on rescuing viable businesses in short-term financial difficulties and the proposed moratorium on debt demands was increased to 45 days from 30 days with a possible further extension of up to 12 months with court approval.

To further enhance employee payments, a new staged payment proposal with a minimum protection equivalent to the Protection of Wages on Insolvency Fund limits for *ex-gratia* payments was suggested. Outstanding wages would be paid within 30 days of the commencement of provisional supervision. A second-stage payment of wages in lieu of notice and severance would be made within 45 days of the approval of the restructuring arrangement, or within 45 days of the extension of the moratorium. These staged payments reduce the outflow of cash by investor before creditors agree on a rescue proposal and, at the same time, preserve the same employee entitlements in the Protection of Wages on Insolvency Fund so that employees are no worse off than in a liquidation.

New legislation on insolvent trading

Quite often corporate rescue attempts commence only after companies find themselves in serious financial difficulties. In order to encourage management directors to address problems at an earlier stage, legislation on 'insolvent

trading' was proposed alongside the government's corporate rescue proposals. Under this proposed legislation, directors could be personally liable for company losses where their company continues to trade when the directors know, or ought to know, that the company is insolvent.

Opponents of this proposed legislation have argued that this threat of personal liability will discourage directors from taking a proactive stand in restructuring attempts. In practice, directors in modern commercial companies should be both knowledgeable enough to read financial statements and aware of their obligation to pay close attention to the company's financial position in tough times.

Moreover, thanks to technological advances, directors have better access to timely information for making informed decisions. The circumstances which may persuade directors to seek help during corporate financial problems go beyond the numbers. Directors need to consider the company's future prospects, its profitability, its competitiveness, the industry climate, stakeholder expectations, corporate social responsibility, as well as their own remuneration packages and potential loss of personal reputation. All these factors could be as important as any concerns about personal liability.

Conclusion

The government's latest proposals to reform Hong Kong's corporate insolvency and winding-up regime (see the consultation document 'Improvement of Corporate Insolvency Law Legislative Proposals' on the Financial Services and Treasury Bureau website: www.fstb.gov.hk) do not include proposals for a statutory corporate rescue procedure and insolvent trading provisions. The government hopes to issue a consultation on new detailed proposals in this area soon.

The marathon to establish a statutory corporate rescue procedure in Hong Kong has already taken over 16 years. This does not compare well with the situation in mainland China – the PRC Enterprise Bankruptcy Law became effective in June 2007, in which corporate reorganisation procedures have been enacted. Time is always of the essence in corporate rescue attempts for listed companies and SMEs alike so perhaps this element should also be recognised in our law drafting process. We need to strike a balance between the interests of all creditors and stakeholders involved, but we also need to consider the reputation of our well-regarded market infrastructure in Hong Kong.

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Automated Trading Services in Hong Kong

By Kent Kwok, *Assistant Accountant*

Hong Kong Mercantile Exchange (HKMEx) is an electronic commodities exchange established in Hong Kong for the trading of commodity futures, options and other financial derivatives. On 18 May 2013, HKMEx ceased to trade upon surrendering its authorisation to provide automated trading services, citing insufficient revenue to support its operating expenses. A few days later, the Hong Kong Securities and Futures Commission (**SFC**) announced it was investigating the suspected irregularities in HKMEx's financial affairs and has referred the matter to the Hong Kong Police.

Automated Trading Services (ATS) in Hong Kong

Before the incident of HKMEx, the general public may not be familiar with the operations of the HKMEx, in particular the "Automated Trading Services", and how these services are regulated in Hong Kong. In this article, we will discuss briefly what is ATS and the relevant guidelines issued by the SFC to regulate the operations managed by HKMEx.

The Guidelines for the Regulation of Automated Trading Services (**the Guidelines**), published under the Securities and Futures Ordinance (Cap 571) (**SFO**) in March 2003, set out the principles, procedures and standards in relation to authorisation, registration, and licensing of persons by the SFC for providing ATS.

According to the Guidelines, the definition of ATS is, inter alia, *"services provided by means of electronic facilities, not being facilities provided by a recognised exchange company or a recognised exchange company or a recognised clearing house"*.

Registration for ATS can be applied under Parts III or V of the SFO, depending on different criteria and requirements. Stock exchange or futures exchange outside of Hong Kong is also eligible for authorisation under the SFO.

As of 18 May 2013, there are 30 approved ATS providers, excluding HKMEx, registered under Part III of the SFO.

Principles for the Regulation of ATS

In general, the provision of ATS should be consistent with and / or promote the regulatory objectives of the SFC. Some of the key principles of ATS include:

- The fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry
- Secure an appropriate degree of protection for members of the public investing in financial products
- Supervise, monitor and regulate the activities carried out by persons regulated by the SFC and the activities of registered institutions

Standard practices

In addition to the general principles, SFC also identified seven core standards of practice for the regulations of ATS:

Standard 1: Financial Resources and Risk Management

An ATS provider should adopt financial resources and risk management policies which comply to prudential and operational standards that apply to authorised financial institutions and licensed dealers.

Standard 2: Operational Integrity

An ATS provider should maintain electronic facilities with adequate security, capacity and contingency arrangements of its electronic facilities.

Standard 3: Fitness

An ATS provider should be a fit and proper person as recognised by an authority in Hong Kong or in its home country.

Standard 4: Record Keeping

An ATS provider should keep full records of its ATS operations.

Standard 5: Transparency

An ATS should provide appropriate levels of transparency to ATS operations and traded products, include where relevant order processing arrangements, transaction execution, settlement arrangements, and operational requirements rules.

Standard 6: Surveillance

Surveillance of ATS activity should be performed by the ATS provider, a regulatory authority (including potentially the SFC), or another competent person, and such surveillance should be consistence with relevant market regulation practices in Hong Kong and internationally.

Standard 7: Reporting

An ATS provider should inform regulatory authorities of its ATS operations and traded products, and any significant changes to those operations.

Questions to think about

Given the Guidelines have been around for 10 years and the recent HKMEx incident, it is worth to consider the following:

- Are the Guidelines appropriate for today's market conditions or should these Guidelines be updated to provide Hong Kong a competitive edge?
- Under the current system, is there sufficient protection for investors who invest via ATS?
- Are ATS providers offering sufficient training for their persons who provide the services, in areas such as ethical and corporate governance?
- Are there appropriate tested contingency plans and detailed procedures in response to emergency situation such as system malfunction?

Conclusion

Market players and investors expect ATS to continue to evolve. To protect and promote Hong Kong as a competitive international financial centre, we need to better monitor the service and operations of the ATS providers.

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What is a "simple case" under the draft regulations of Simplified Merger Review Process?

By Corporate Finance Team

In an effort to streamline the merger review process, the Ministry of Commerce of the PRC (**MOFCOM**) published on 3 April 2013 a draft interim Regulations on Standards for Simple Cases of Concentrations of Business Operators (**Draft Regulations**) for public consultation. The Draft Regulations set out standards for simple merger cases that can be subject to a fast-track review / clearance process. The Draft Regulations are encouraging step towards the development of a simplified procedure for cases that are unlikely to raise competitive concerns. According to the Draft Regulations, a merger will be treated as a simple case under any of the circumstances shown in the below table.

The Draft Regulations also state that mergers under certain circumstances will not be treated as simple cases. These circumstances include: concentrations which may cause adverse impacts on consumers, market entry or technology development, etc.

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Type of merger	Requirements
Horizontal merger	Aggregate market share of ***all*** business operators involved in the concentration in the same relevant markets < 15%
Vertical merger	Market share of ***each*** of the business operators involved in the concentration in each of the upstream and downstream markets < 25%
Merger that is neither horizontal nor vertical	Market share of ***each*** of the business operators involved in the concentration in each market < 25%
Establishment of an overseas joint venture	The concerned enterprise does not engage in any business operation in China.
Acquisition of equity or assets of an overseas enterprise	The concerned enterprise does not engage in any business operation in China.
Change of controlling shareholders of a joint venture	Subsequent to the concentration, the JV originally controlled by more than two business operators comes under the control of one or more business operators.

An update on the Bankruptcy Ordinance (Cap. 6)

By Anita Hou, *Partner*

Section 30A(10)(a) of the Bankruptcy Ordinance

Following up on our last eBulletin's discussion on the constitutionality issue of Section 30A(10)(a) of Bankruptcy Ordinance (**the Section**), we are informed by the Official Receiver's Office (**ORO**) that the High Court of Hong Kong handed down a ruling on 2 May 2013 and confirms that the Section is constitutional. ORO further explains that *"the ruling mainly affects those bankrupts who have left Hong Kong before the making of bankruptcy orders and are not present in Hong Kong on the date of the bankruptcy orders (the affected bankrupts). The court has ruled that it is constitutional to suspend to running of the prescribed relevant period (i.e. 4 years for first-time bankruptcy and 5 years for multi-time bankruptcy) of the affected bankrupts under the Section until such time as they return to Hong Kong and notify the trustee of their return."*

It is noted that the above ruling is subject to appeal. We shall keep the reader updated if there is further development in the matter.

Reader may refer to our previous bulletins for discussions of the Section and other matters relating to bankruptcy in Hong Kong.

Section 30A(10)(a) : *when a bankrupt has, before the commencement of the bankruptcy, left Hong Kong and has not returned thereafter, the relevant period that a bankrupt is discharged from bankruptcy by the expiration of the relevant period, shall not commence to run until such time as he returns to Hong Kong and notifies the trustee of his return.*

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Sharing - A trip to the INSOL International Congress

By Christina Lam, *Director*

The Ninth World Congress of INSOL International was held at The Hague, Netherlands from 19 to 22 May 2013 with over 650 delegates coming from countries over the world. Four members of our SAS team, including three partners and one director, attended the Congress and shared their practical insights and challenges as well as war stories with these delegates who are judges, academicians, legal professionals and insolvency practitioners.

Extensive and comprehensive topics were covered in the Congress, including but not limited to the impact from the global financial crisis, criminal elements of restructuring, harmonisation of insolvency laws, cross-border approaches to the valuation of distressed enterprise, trends and predictions in China, etc. Amongst all the distinguish speakers, Judge Ye Bingkun of Xiamen Intermediate People's Court of the PRC was invited by INSOL to share his comments on the relevant restructuring / insolvency laws and practices in China.

Apart from the conference and seminars, our partners and director were also invited by some reputable legal and professional firms in Netherlands to join their cocktail reception and dinner that held at art museums. They had a good time in learning the history and knowledge of different arts and paintings in Holland.

Delegates are looking forward to the next INSOL 2014 Asia Pacific Regional Conference to be held in ….. HONG KONG!

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FIS Insight Workshops

The second series of SAS Insight Workshops, focusing on computer and digital investigation, was completed on 29 May 2013. The workshops, comprising four sessions, attracted participants who come from lawyer firms, private equity / investment companies, private and listed corporations. Apart from updating knowledge and trends on digital evidence and investigation, participants were given chances to act as computer forensic examiners and work with advanced forensic tools to search and identify electronic evidence in an IP infringement case.

ACFE Investigation Course

Anita Hou, partner of SAS, was invited to speak, for the Hong Kong Chapter of Association of Certified Fraud Examiners, on forensic accounting in their Foundation Investigation Course in June 2013.

Feedback from readers is essential to our success. We welcome and value your comments or suggestions. Feel free to contact us for any questions as well.

Hong Kong Institute of Certified Public Accountants

Anita and Terry Kan, another partner of SAS, were invited to speak in various insolvency courses organised by the Hong Kong Institute of Certified Public Accountants during March, April and July 2013.

CPA Australia Seminar

Terry and Anita spoke on *Corporate Rescue Regime in Hong Kong and the PRC,* and *Deciphering "cooked books" and lifting the veil of phantom companies* respectively, in June 2013 for members of CPA Australia in Hong Kong.

Corporate trainings

Anita, together with Matthew Chu, senior manager of SAS, were invited to speak to various law firms in Hong Kong, during April to June 2013, on topics relating to forensic and digital investigations.

For those of you who are interested to explore our seminars in topics such as liquidation and restructuring, forensics and digital investigations, please do not hesitate to contact us to arrange for a tailored session at sasmarketing@shinewing.hk.