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A general guide to Hong Kong's restructuring and insolvency laws

Legislation

In the Hong Kong Special Administration Region of the People's Republic of China (Hong Kong), the laws in force in Hong Kong as at 30 June 1997 were adopted as the laws with effect from 1 July 1997, except for those which the Standing Committee of the National People's Congress of the PRC declared to be in contravention of the Basic Law, i.e., the national law of the PRC.

Hong Kong's insolvency regime is based mainly on that of the United Kingdom and the emphasis is on the realisation of assets for the benefit of creditors rather than the rescue of companies. The legislation concerning corporate insolvency is contained largely in the Companies Ordinance and the Companies (Winding-up) Rules. Certain provisions of the Bankruptcy Ordinance (and the related Bankruptcy Rules) are also applicable in the liquidation of insolvent companies.

Insolvency procedures

Corporate insolvency proceedings available include:

- contractual arrangements;
- schemes of arrangement;
- creditors' voluntary liquidations;
- compulsory liquidations;
- court liquidation under a regulating order;
- receivership

In addition to the above insolvency procedures, solvent or defunct companies may be disposed of by way of:-

- members' voluntary liquidation;
- striking off

There are presently no specific licensing or registration requirements for insolvency practitioners; however, in nearly all cases, they are certified public accountants registered under the Professional Accountants Ordinance.

Contractual arrangement

Contractual arrangements, known as restructuring or workouts, are by mutual agreement between the debtor company and its creditors. There is no need to involve the court. The terms of the arrangement are set by the parties involved. The company and the creditors are contractually bound by the terms of the arrangement.

In practice, the terms require 100 per cent agreement by the relevant class or classes of creditors concerned to prevent one dissenting creditor from commencing winding-up proceedings. With regard to financial creditors, the Hong Kong Monetary Authority ('HKMA') and the Hong Kong Association

of Banks ('HKAB') have issued formal but non-statutory guidelines on multiple bank restructurings. The rules stress the importance of banks acting quickly but providing sufficient liquidity to obtain a considered view of the borrower's future prospects. The guidelines also state that where a clear majority of the banks agree to support a company, others should carefully review their own positions.

Once approved, creditors will have close control over the implementation of the arrangement. They would normally form a steering committee with an insolvency practitioner as supervisor or trustee to monitor progress. The HKMA and the HKMB guidelines stress that the members of the committee should be of sufficient seniority to be able to take and implement recovery decisions quickly.

Scheme of arrangement

A scheme of arrangement is essentially the same as a contractual arrangement except that a scheme requires agreement by at least 75 per cent in value and 50 per cent in number of the creditors voting at the relevant meetings and must be sanctioned by the court.

Although agreement by 100 per cent of the creditors voting is not required, once approved by the court, the scheme is binding on all creditors.

Creditors' voluntary liquidation

Somewhat contrary to what the name suggests, creditors have no role in initiating creditors' voluntary liquidations. The directors of a company, realising that there may be no real prospects of the company meeting demands of creditors, call an extraordinary general meeting (EGM) when members may resolve, by a special resolution, to wind up the company.

A meeting of creditors held after the EGM (on the same day as or the day following the EGM) would then confirm the appointment of a liquidator (if any) as proposed by the members or make their own appointment. They may also form a committee of inspection of not more than five persons (including any nominated by members at the EGM) to assist the liquidator with the liquidation administration.

Creditors may have considerable influence over the handling of the administration by the liquidator as certain powers of the liquidator are only exercised with sanction from the creditors at a meeting, the committee of inspection or the court.

As an alternative to the above, the majority of the directors of a company, may resolve at a meeting called for that purpose to have the company wound up and that one of them should make the requisite statutory declaration and file the same with the Companies Registry under s. 228A of the Companies Ordinance. Thus a company may be put into liquidation without any resolution from members or creditors. Members and creditors meet subsequently to decide mainly on the choice of the liquidator. A provisional liquidator is usually appointed by the directors to safeguard the assets of the company during the interim period. This method of commencing a liquidation is unique to Hong Kong.

Compulsory liquidation

Compulsory liquidation is set in motion by the presentation of a winding-up petition. Although the company itself may, after passing a special resolution to that effect, apply by way of petition to the court to wind up, most compulsory or court liquidations are initiated by unsatisfied judgment creditors or creditors who have served a 'statutory demand' on the company but have not received payment within 21 days.

Relevant government officials may also file the petition if authorised to do so by law, e.g., the Financial Secretary under the Banking Ordinance or the Companies Ordinance or the Securities and Futures Commission under the Securities and Futures Ordinance.

A provisional liquidator (usually the Official Receiver) may be appointed by the court to protect the assets of the company after the filing but before the hearing of the petition. A special manager may also be appointed by the court upon the application of the provisional liquidator, to assist with management of the affairs of the company.

When the winding-up order is made, the Official Receiver, if not yet the provisional liquidator, automatically becomes the provisional liquidator. The Official Receiver then arranges for the first meetings of the contributors and creditors of the company (to be held normally within three months of the granting of the winding-up order). At these meetings, contributors and creditors may appoint a liquidator to replace the Official Receiver and appoint a committee of inspection, as in the case of a creditor's voluntary liquidation. Contributories refer to persons who may be liable to contribute to the assets of an insolvent liquidation. Though somewhat misleading, contributories include shareholders who have paid up in full for their shares in limited companies.

It is possible for creditors in a compulsory liquidation to resolve at a meeting to apply to the court to convert the liquidation into a creditors' voluntary liquidation. Application has to be made within three months from the first meeting of the creditors.

Formal proofs of debts are required to be filed with the liquidator before claims may be adjudicated.

Although the Official Receiver may not be acting as liquidator of a company under compulsory liquidation, he still maintains his supervisory role in the administration. Upon filing of the liquidation receipts and payments accounts (every six months), he may request that his office audit the liquidator's accounts. Funds received by the liquidator (subject to an amount agreed to be retained) must be remitted to and disbursed from the Companies Liquidation Account under the control of the Official Receiver's Office.

Court liquidations under a regulating order

Under specific circumstances, e.g., due to the large number of creditors or contributors, adherence to full procedures of a compulsory liquidation may not be appropriate or cost-effective. The court may order that the relevant liquidation be conducted under a regulatory order.

The main divergence from normal compulsory liquidation procedures is that no meetings of contributories or creditors need be held to appoint a liquidator or a committee of inspection. The appointments of the liquidator and/or committee are made directly by the court.

Receivership

A receiver is a person, normally an insolvency practitioner, appointed to take possession of specific property to safeguard it, to receive income from it or to dispose of it. Where the receiver takes control of the general conduct of a business (including assets), he is called a receiver and manager. A receiver does not wind up or liquidate the company.

Receivers are usually appointed under debentures or charge documents granted in favour of a bank, as security for lending or general banking facilities, after the customer fails to repay the loans as demanded by the bank. The debenture may incorporate charges on specific property (fixed charge) or

the general business undertaking of a company (floating charge) under the Companies Ordinance. The security thus afforded to the debenture holder may be a fixed charge, a floating charge or a combination of both.

The court may appoint a receiver, for example, to safeguard property, which is the subject of a dispute or pursuant to a charging order in debt recovery actions.

The receiver's primary duty is to the debenture holder who appointed him and his task is to realise sufficient assets to pay off the debt due to his appointee. Where the appointment is under a floating charge, or a charge originally created as such, the receiver would need first to settle the claims of the preferential creditors, who take precedence over the floating charge debenture holder.

Whilst the receiver is not appointed by the general body of creditors and he does not have any statutory responsibility to call meetings of creditors or to account to them for his administration, a receiver should nonetheless have regard to the possible interest of the unsecured creditors in disposing of the assets under the charge. As a matter of professional courtesy and particularly where the receiver is attempting over a prolonged period of time to dispose of the business as a going concern, he may wish to retain the goodwill and cooperation of the general body of creditors by issuing to them periodic reports of the progress of the receivership.

If there are surplus funds after payment to the debenture holder, these should be returned to the company or passed to any liquidator appointed. The receiver would not be paying any dividends to unsecured creditors in any case.

Potential benefits
The appointment of receivers (and managers) can:

- help preserve the value of the secured assets of a business, thereby protecting the interests of the secured lenders; and
- result in the disposal of the business as a going concern, if possible, thus enhancing the return for secured lenders.

Statement of affairs

In all kinds of insolvency proceedings, the financial position of a company must be summarised and presented as a statement of affairs within a period normally not more than 28 days from commencement of the relevant proceedings, except in the case of members' voluntary liquidations where the statement has to be incorporated in the declaration of solvency. In a compulsory liquidation and a receivership, the statement in a statutory prescribed form sets out the assets and liabilities of the company as at the date of the winding-up order or receivership, as well as the estimated realisable values of those assets. A list of creditors with their estimated claims is usually included. Statements of affairs used for voluntary liquidation or voluntary arrangements do not have any particular set format but practitioners tend to follow the format as prescribed with due modifications as appropriate.

Recovery of assets

Liquidators of companies are empowered to undertake investigations and, where offences involving fraud or deception are proved, may seek redress personally against the directors and officers concerned, who may be required to repay or restore the property to the company or make such other pecuniary compensation or contribution to the assets of the company as the court considers appropriate. In more severe cases, criminal prosecution may follow and, where convicted, the relevant director or officer may be imprisoned. Malpractice includes:

- fraudulent trading, where the business is carried on with intent to defraud creditors or for any other fraudulent purpose;

- misfeasance, where directors have breached their fiduciary duties to the company or have misapplied or retained property of the company for their personal benefit;

- unfair preference or transactions at an undervalue: the liquidator may challenge transactions at an undervalue, or creditors who have been preferred against any other creditors by the company within six months of commencement of the liquidation; the six-month period is increased to two years in the case of associates, which is widely defined to include transfers between directors and members of their families;

- disposition after commencement of compulsory liquidation; these dispositions or payments are void against the liquidator and the recipients of these funds or assets have to return the funds or assets to the liquidator;

- destruction or falsification of books and records: directors and officers may be charged for the intentional destruction or falsification of books and records of a company within 12 months of the commencement of liquidation (no time limit for falsification) or thereafter.

Auditors, liquidators and receivers of a company may be regarded as officers for these purposes.

Dissolution of companies

In a voluntary liquidation, the liquidator calls final meetings of contributories and/or creditors to obtain his or her release. The company is deemed to be dissolved three months after filing by the liquidator of the final accounts and return of the final meetings with the Registrar of Companies.

In a compulsory liquidation, the liquidator files the final accounts with the court and may then obtain from the court his or her release as liquidator. The official receiver then files the relevant certificate with the Registrar of Companies and the company is deemed to be dissolved two years after this certificate has been registered. Upon application for release, the liquidator may apply at the same time for the dissolution of the company, in which case the company dissolves as and when the court orders.

Striking off

Every company incorporated in Hong Kong is registered with the Registrar of Companies. When a company ceases to exist, e.g., dissolved following formal liquidation procedures, it is struck off the register. A private limited company can apply for de-registration as a 'defunct company' under s. 291AA of the Companies Ordinance, which provides a simplified procedure for dissolving a defunct, solvent company.

Where companies have become dormant for a prolonged period of time and have defaulted on various statutory duties regarding the filing of returns etc., the Registrar of Companies may take steps to strike them off the register. Alternatively, the directors of a dormant company may apply to the Register of Companies to strike off the company. The directors will be expected to provide reasons for the application, state the activities and financial position of the company and explain why formal liquidation procedures have not been adopted.

Where appropriate, the Registrar will advertise an intention to strike off a company in the *Government Gazette* and, if no objection is received before the set deadline, will strike off the company, which will cease to exist.

Restoration of companies

There are express provisions in the Companies Ordinance for companies which have been dissolved or struck off to be restored to the register, for specific purposes and under circumstances specified. These invariably require that an application be made to the court by the interested party and the restoration will be by way of a court order.

Creditors

In insolvency proceedings generally, the assets available will be distributed amongst the various types of claims in the following order:

- costs and expenses of the insolvency proceeding, including the remuneration of the insolvency practitioner;
- creditors secured by a fixed charge;
- preferential creditors, e.g., certain debts due to employees or the government;
- creditors secured by a floating charge;
- unsecured creditors in general.

Where there are insufficient funds to pay any class of the claims in full, payment will be made pro rata. Where there are surplus funds after payment of all the above claims, interest accruing during the period of the insolvency proceedings (where appropriate) will be paid before any funds are returned to the shareholders.

Other matters

At present, Hong Kong does not have a formal statutory rescue procedure for companies in financial difficulty. The absence of a stay or moratorium on creditor enforcement action while a restructuring is being worked out can be a significant problem for a company. The insolvency subcommittee of the Law Reform Commission of Hong Kong has produced draft legislation to introduce a framework for 'provisional supervision' which would impose a 30-day moratorium on creditor action while a reorganisation plan is set up under the supervision of the court.

The committee also produced draft legislation to introduce the concept of 'insolvent trading' and impose a liability on a company's directors, shadow directors and 'senior management' to compensate a company if they have allowed the company to continue trading and incur debt when they knew, or ought reasonably to have known, that the company was insolvent or there was no reasonable prospect of it avoiding insolvency.

It is not certain when these provisions will be incorporated into a new Bill to be put before the Hong Kong Legislative Council and therefore to what extent these new provisions will become law.

Other recommendations of the committee include:

- the creation of a single Insolvency Ordinance to combine all insolvency legislation;
- the licensing of insolvency practitioners;
- the improvement of liquidators' powers to investigate and challenge antecedent transactions;
- streamlining the administration of liquidations;
- reducing the size and numbers of preferential claims.

How KPMG can help

KPMG and its partners can assist in each of the areas outlined above by providing pre-engagement advice and accepting formal appointments as receiver, liquidator, trustee-in-bankruptcy and provisional liquidator.

Notice

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice a thorough examination of the particular situation.