Hong Kong, China

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The insolvency law in Hong Kong, China is contained in the Companies Ordinance, the Bankruptcy Ordinance and the Companies (Winding-up) Rules. It is based on the law of the United Kingdom, prior to the introduction of the Cork Report. Like the regimes in Australia and New Zealand – also UK-based jurisdictions – it is generally creditor friendly.

Out-of-court restructuring, schemes of arrangement, compulsory liquidations, creditors' voluntary liquidations and receiverships are available under the insolvency law. No corporate rescue procedure is currently available.

In 1996 the Law Reform Commission published a report advocating a corporate rescue procedure known as provisional supervision. A bill was gazetted in May 2001 with a view to enacting the legislation, but progress has been slow and the proposed bill has not yet been passed. With no statutory rescue mechanism in Hong Kong, China, creditors of a company in financial difficulty must pursue an informal restructuring process or enter into a scheme of arrangement.

Recently, the courts have proved themselves willing to appoint provisional liquidators to explore and implement restructuring and corporate rescue arrangements. If a rescue is not ultimately possible, winding-up follows and the provisional liquidators revert to their traditional role of preserving the assets of the company prior to the winding-up order being made.

1. Legal framework and the effectiveness of court processes/legal remedies

1.1 Describe the nature and effectiveness of the following:

(a) Debt recovery remedies where the creditor has no security

Five principal remedies are available to judgment creditors:

- Winding-up proceedings – these are available to judgment creditors as well as to non-judgment creditors that have a debt which is not genuinely disputed. Bankruptcy proceedings in Hong Kong, China are analogous to winding-up proceedings, except that they operate *vis-à-vis* individuals. Winding-up proceedings are an effective, if draconian, alternative to pursuing judgment remedies or remedies enforcing debts. They have a potentially serious impact on the debtor's business or affairs. The effect of a winding-up petition is to prohibit all dispositions of the debtor's assets without leave of the court.
- Garnishee proceedings – these are launched against a third party (the garnishee) by a judgment creditor to recover an amount owed to the judgment creditor by a judgment debtor. The proceedings are in respect of amounts owed by the garnishee to the judgment debtor. This remedy is especially effective to 'garnish' monies in the judgment debtor's bank account.

- A writ of *fieri facias* – this can be issued over a judgment debtor's goods and chattels (movable property). If issued, it will order a court officer to seize as much of the debtor's goods and chattels as may be sufficient to realise the judgment debt and expenses, and then sell those assets.
- A charging order – this puts a judgment creditor in the position of a secured creditor and can be taken over immovable property, subject to any prior mortgages and charges affecting the property. A judgment creditor can also seek by similar procedures a charging order over a judgment debtor's beneficial interest in chattels such as ships or aircraft and securities.
- Examination – judgment debtors can be examined to obtain information about their means. This can be valuable in supplementing information already known to the judgment creditor and filling in any gaps in knowledge.

(b) The enforcement of security

The main remedies generally provided by security documents are:

- foreclosure;
- appointment of a receiver over the secured assets;
- taking possession of the secured assets; and
- sale of the secured assets.

Normally, security documentation confers a power on the chargee/mortgagee to appoint a receiver without a court order, as well as a right to take possession of the secured assets and exercise a power of sale.

(c) Corporate bankruptcy/liquidation processes

Creditors can petition the court for the compulsory winding-up of a company. Among other things, the creditor must show the inability of the company to pay its debts.

Members' voluntary winding-up occurs when the members, by special resolution (75 per cent), resolve to wind up the company and the directors make a declaration of solvency in accordance with the Companies Ordinance (ie, the company must be solvent to undertake this procedure). The liquidator is appointed by the company in general meeting.

Creditors' voluntary winding-up occurs if the company arranges for a creditors' meeting to be summoned immediately after a general meeting sanctioning the winding-up of the company. Creditors then have the right to appoint their own liquidator to replace the company's nominated liquidator.

(d) Formal corporate rescue processes

As the provisional supervision legislation is still pending, a scheme of arrangement is the only formal corporate rescue process available in Hong Kong, China.

A scheme of arrangement is initiated by filing an application, explanatory statement, notices of meeting and forms of proxy with the High Court. The court will then provide directions as to the timing and location of the creditors' meetings.

Once directions have been received, the notices, forms of proxy and explanatory statement must be sent to all known creditors, as well as advertised. An explanatory statement must give sufficient information to creditors to enable them to decide whether to approve the scheme. Any creditors whose claims have not been addressed in the scheme retain their full original rights against the company after the scheme has been implemented.

Creditors' meetings are held by class of creditor, whereby creditors decide whether to approve the scheme. Separate meetings are held for each class of creditor. A resolution approving the scheme must be passed at each meeting of each class by a majority in number representing at least 75 per cent in value of those present and voting, including by proxy. If the scheme is approved, there should also be a general meeting of the company's shareholders, and if necessary a board meeting, to approve the company entering into the scheme of arrangement.

Once all meetings of creditors and shareholders have taken place, another petition must be presented to the High Court for approval of the scheme. The scheme takes effect upon filing of the court order sanctioning the scheme with the registrar of companies.

As these procedures suggest, a scheme of arrangement can be a complicated exercise. A straightforward scheme is likely to take at least two months, with more complex schemes taking more than six months.

In the past few years in Hong Kong, China, the High Court has commonly granted provisional liquidators restructuring powers upon their appointment. Schemes of arrangement have been used successfully by provisional liquidators in such

circumstances to return companies to solvency with the approval of the court. The comparative stability offered by a provisional liquidation – particularly the moratorium on legal proceedings – provides space within which a scheme can be developed.

(e) Informal corporate rescue processes

The Hong Kong Monetary Authority and the Hong Kong Association of Banks have jointly published non-binding recommendations and guidelines called "The Hong Kong Approach to Corporate Difficulties". The guidelines encourage banks to support debtors and make decisions based only on information that is reliable and shared with all banks. The guidelines encourage collective decisions and equal treatment of banks, tempered by certain restrictions on the borrower's activities. The informal corporate rescue process is undertaken by contract.

1.2 What are the formal processes to effect a liquidation of the company's assets?

Voluntary winding-up: There are two types of voluntary winding up – members' voluntary winding-up and creditors' voluntary winding-up. Both are out-of-court procedures.

Creditors' voluntary winding-up is used for insolvent companies. It is usually commenced by the directors convening meetings of members and creditors once they have concluded that the company is insolvent and there are no real prospects of restructuring. The creditors' meeting is held immediately after the members' meeting; its main function is to enable the creditors to choose their own liquidator (if they wish to choose someone other than the person chosen by the members), and appoint a committee of inspection to supervise the liquidation. Despite the name 'voluntary' liquidation, if the members have passed a resolution for the company's winding-up in good faith, the creditors have no grounds on which to dispute it. Creditors may challenge the resolution only on the grounds that the shareholders have acted in bad faith.

A majority of directors may also resolve (under Section 228A of the Companies Ordinance) to wind up the company on the basis that the company cannot, by reason of its liabilities, continue its business and that they are of the opinion that it is not reasonably practicable for the winding-up to be commenced in any other way. Directors may be liable for fines or imprisonment if they make the declaration without reasonable grounds for doing so. This means of commencing winding-up is not often used. The winding-up is deemed to have commenced when the directors file the declaration. Like other creditors' voluntary liquidations, the creditors' meeting held subsequently cannot stop the winding-up.

Members' voluntary winding-up is used for solvent companies, usually when the members of the company no longer wish the company to exist. The creditors are paid in full before distributing any surplus to shareholders. The majority of the directors must make a declaration of solvency, stating that the company is able to pay its debts in full within 12 months of commencement of the winding-up. A director may be liable to a fine or imprisonment if he makes a declaration of solvency without reasonable grounds for doing so. The winding-up is commenced by the members of the company passing a special resolution (75 per cent) at an extraordinary general meeting.

Compulsory winding-up: A contributory or creditor of the company may present a petition for winding-up. Once presented, a petition cannot be withdrawn, as only the court has the power to dismiss the petition. If shareholders have passed a resolution for winding-up, the company itself may present a petition. A petition may be presented on a number of grounds, including insolvency and just and equitable grounds. Most commonly, compulsory winding-up is initiated by a creditor presenting a winding-up petition against the company on the grounds of insolvency.

1.3 What is the effect on debt collection and the enforcement of security of:

(a) An adjudication of corporate bankruptcy/ liquidation?

Many enforcement proceedings against a company become void upon the commencement of a winding-up. The commencement date is the date on which the winding-up petition is presented (in a winding-up by the court) or the date on which the resolution is passed (in a voluntary winding-up). Generally, all actions against the company are stayed by a winding-up order. Where a winding-up order has been made, 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. Similarly, the appointment of a provisional liquidator also

stays all actions.

On liquidation, a secured creditor may still appoint a receiver. On liquidation of the company, the receiver ceases to act as the company's agent. Secured creditors may realise their security and obtain payment in full. They do not have to prove a claim in the liquidation. If the value of the security of a secured creditor is less than the outstanding claim, they may prove for the shortfall in the liquidation.

(b) The commencement of a formal corporate rescue process?

Before a scheme of arrangement is approved, a creditor may enforce its debts, a secured creditor may enforce its security and a creditor may file a winding-up petition. There is no mechanism to prevent individual creditors from enforcing their debts, apart from through the appointment of provisional liquidators.

(c) The initiation of an informal corporate rescue process?

If an informal corporate rescue process is initiated, creditors are free to pursue their remedies as they see fit, although informal standstill arrangements between financial creditors are common. The effect of an informal corporate rescue on debt and security enforcement processes against a company is a matter of contract between the company and each of its separate creditors.

(d) The initiation of an insolvency or insolvency-related process under any special legislation?

Not applicable.

1.4 Are insolvency procedures involving a corporation incorporated in your jurisdiction recognised if they are started in another jurisdiction?

There is no statutory basis for recognition or assistance with foreign insolvency proceedings. However, the courts in Hong Kong, China have shown a willingness to cooperate with the courts of foreign jurisdictions. As a matter of practicality, the courts in Hong Kong, China will recognise foreign insolvency proceedings and representatives appointed in such proceedings, and will recognise the foreign representatives' powers to collect assets. It is recommended that separate winding-up proceedings be initiated in Hong Kong, China where a foreign representative seeks to protect the collective nature of the foreign proceedings (eg, by restraining creditors from attaching assets).

1.5 In what circumstances would the directors or officers of a company in financial difficulties face potential personal liability for continuing to trade? In practice, are any such provisions actually enforced?

Hong Kong, China company law provides penalties for 'fraudulent trading', which means carrying on any business of the company with the intent to defraud the company's creditors or creditors of another party, or for any fraudulent purpose. Any person (including a director) who was knowingly party to the carrying on of the business in such manner will be personally liable for debts or liabilities as the court may direct. Such behaviour is considered a criminal offence. It is not only directors who are liable; any person who was knowingly party to the carrying on of the business in such a manner is also liable. A director who commits fraudulent trading may be disqualified from acting as a director for up to 15 years.

A company carries on business with intent to defraud if there is no reasonable prospect of the creditors ever receiving payment of their debts in full. This is particularly important in relation to incurring new credit, including inducing a supplier to supply goods knowing they will not be paid for. Carrying on business is not necessarily restricted to trading activities, but also includes the collection of assets acquired in the course of business and distribution of the proceeds of those assets in the discharge of business liabilities.

There have been few cases proving fraudulent trading in Hong Kong, China, as it is very difficult to prove. Actual dishonesty must be shown.

2. What are the advantages and disadvantages of triggering a formal procedure?

The primary advantage of a scheme of arrangement is that it does not require the consent of all creditors. Once the court approves the scheme, it is binding on all creditors in each class approving the scheme.

However, schemes of arrangement can be slow and costly. There is considerable uncertainty, particularly as regards the court timetable, the lack of a moratorium or stay of proceedings, and the lack of implied powers for scheme administrators.

3. What are the practical options for out-of-court restructuring?

Hong Kong, China has no statutory rescue mechanism and there is considerable flexibility with regards to out-of-court restructuring and/or rescheduling of a company's debts. An informal restructuring may take many different forms, including:

- a simple debt rescheduling (ie, bankers agreeing to give the company more time to pay its debts);
- a debt rescheduling and 'haircut' (ie, creditors agreeing to accept less than 100 per cent of the debt); and
- debt-for-equity swaps.

Creditors of a company in financial difficulties in Hong Kong, China very much rely on the company's bankers (usually the major creditors) in reaching a restructuring agreement. Such bank-led restructurings are often difficult to negotiate, as it is common for companies in Hong Kong, China to have 10 to 20 bankers, all of which have different policies and attitudes. Bank-led restructurings in Hong Kong, China usually involve:

- a liaison or lead bank;
- steering committees to facilitate communications;
- an informal standstill to give breathing space to the company; and
- the appointment of independent financial advisers.

Notwithstanding their differing views and policies, banks in Hong Kong, China follow the guidelines set out in "The Hong Kong Approach to Corporate Difficulties", issued jointly by the Hong Kong Monetary Authority and the Hong Kong Association of Banks, when pursuing out-of-court restructurings. Although the guidelines are voluntary, they are strongly supported by the Hong Kong Monetary Authority and the Hong Kong Association of Banks and their members, as they represent accepted practice in the banking community. However, since the guidelines apply only to banks, practical difficulties arise when there are many creditors from different sectors. Out-of-court restructurings may not involve all creditors, and dissenting creditor groups may emerge. Under existing law, the only option to create a legally binding restructuring against the wishes of a dissenting creditor group is via a scheme of arrangement.

4. What is the effect on the management of a company of:

4.1 An adjudication of corporate bankruptcy/liquidation?

After winding-up, the powers of the board of directors cease. Directors retain only residual powers, such as the power to appeal against the winding-up order.

4.2 The commencement of a formal corporate rescue process?

A scheme of arrangement must set out the powers of the scheme administrator (usually an insolvency practitioner), and these may replace the management powers of directors. Application to the court to convene meetings to consider a scheme of arrangement does not restrict the powers of a company's management.

4.3 The initiation of an informal corporate rescue process?

Management retains its powers in an informal corporate rescue process, unless a standstill agreement limiting those powers is in place.

4.4 The initiation of an insolvency or insolvency-related process under any special legislation?

Not applicable.

5. Roles of key players involved in the restructuring and insolvency process

5.1 Who is responsible for the 'case management' control and administration of a corporate bankruptcy/liquidation, a formal rescue or an informal rescue?

Whether voluntary or compulsory, solvent or insolvent, administration of a liquidation is undertaken by the liquidator – usually an insolvency practitioner. Creditors may appoint a committee of inspection to assist the liquidator in his duties. The liquidator may seek directions from the court on any matter.

Under a scheme of arrangement, the company is responsible for managing the formal rescue. There is often a steering committee of financial creditors. A scheme administrator generally manages the administration of the scheme of arrangement itself.

In an informal rescue, control usually remains with the company's management. The major creditors may seek to exert some control through a standstill agreement.

5.2 Who is responsible for the 'case management' control and administration of a case of corporate insolvency under any special legislation?

Not applicable.

5.3 Who is responsible for preparing the restructuring plan in a formal or informal rescue?

In a scheme of arrangement, the company and its legal and financial advisers are responsible for preparing the scheme documents incorporating the rescue or restructuring plan.

In an informal rescue, the restructuring plan is usually prepared by the company's legal and financial advisers, together with the legal and financial advisers of the steering committee of creditors. Communication between the company and its creditors at all times greatly increases the prospects of a successful restructuring.

5.4 Who is responsible for preparing the restructuring plan in a case of corporate insolvency under any special legislation?

Not applicable.

6. What financial information is available to creditors in a corporate bankruptcy/liquidation, a formal rescue and an informal rescue?

Corporate bankruptcy/liquidation: Shortly after the appointment of a liquidator, the directors of an insolvent company are required to prepare a statement of affairs. This document details the assets and liabilities as at the commencement of the liquidation, and gives an estimated outcome. The statement of affairs is made available at the first creditors' meeting and at the request of creditors during the course of the liquidation.

At six-monthly intervals the liquidators must file a statement of receipts and payments with the Official Receiver's Office (for voluntary liquidations) or with the court (for compulsory liquidations). Creditors may obtain copies of the statements of receipts and payments. It is common practice in larger liquidations for liquidators to prepare detailed reports to provide creditors with additional information.

Formal rescue: A detailed explanatory statement is prepared for a scheme of arrangement. An explanatory statement typically contains information about the company's assets, the effect of the proposed scheme and a comparison of what creditors might obtain in a liquidation, to enable them to decide whether it is in their best interests to accept the scheme or go ahead with liquidation.

Informal rescue: Generally, an independent financial adviser is appointed by major creditors – usually banks – to assess the borrower's current and prospective financial position. Banks or a steering committee of financial creditors may agree to an informal standstill (eg, a standstill on repayment of principal), to allow a borrower time to formulate a restructuring plan. In consideration, the borrower may agree to the monitoring of its cash flow by an independent third party. Under the guidelines set out in "The Hong Kong Approach to Corporate Difficulties", financial information should be made available to all bank creditors to allow them to make an informed and collective decision regarding the borrower's debt and any restructuring thereof.

7. Financial issues

7.1 What are the main areas from which funding is generally utilised by companies undertaking either formal or informal restructuring?

The most common forms of funding for Hong Kong, China companies undergoing restructuring are as follows:

- through a 'white knight' or associates of shareholders (ie, friendly investors usually interested in a long-term stake);
- genuine third-party investors;
- creditors' refinancing – where creditors either write off debt or convert to equity to release cash flow; and
- through a 'black knight' – investors that squeeze shareholders and creditors.

There appears to be some scope for bank financing when a company first owns up to its financial difficulties. At that stage, banks may choose to fund working capital for a short period while they explore their options.

In large-scale workouts and insolvencies, it is often the case that the company's underlying debt

will be purchased by distressed debt specialists. Usually these traders enter the market after a company is known to be in a workout situation or has been placed into liquidation. While this does not affect the funding of companies in financial difficulties, such traders normally demand a seat at the negotiating table.

7.2 In what order are creditors paid in a corporate bankruptcy/liquidation?

Funds realised from the assets of a company in liquidation must be distributed in the following order:

- to fixed charge holders, up to the amount of the proceeds from the assets subject to the fixed charges;
- to meet expenses incurred in the liquidation;
- to the liquidator for his remuneration;
- to holders of preferential debts (eg, employees);
- to floating charge holders, up to the amount of the proceeds from the assets subject to the floating charges;
- to unsecured creditors;
- for interest on all debts; and
- to shareholders, according to their rights and interests in the company.

Distribution among each class (other than secured creditors) is *pari passu* by reference to the value of claims as accepted by the liquidator. *Pari passu* distribution is mandatory and is one of the fundamental principles of Hong Kong, China corporate insolvency law.

7.3 Are there any legal provisions that might operate to invalidate the creation of security, the disposal of an asset or the payment of a creditor by a company in financial difficulties?

A number of transactions may be voided by a liquidator. The most important are as follows:

- transactions open to challenge under general law. These might include cases where there has been an abuse of power or where there was an absence of corporate benefit. Such transactions may be voided if the recipient of the consideration knew or ought to have known of the undue influence or the absence of corporate benefit;
- registrable but unregistered charges (Sections 80 and 267 of the Companies Ordinance);
- transactions that create an unfair preference (Sections 266 and 266B of the Companies Ordinance);
- floating charges given by an insolvent company within 12 months of commencement of the winding-up (Section 267 of the Companies Ordinance);
- dispositions of the company's property made without leave of the court after the commencement of winding-up (Section 182 (compulsory liquidation) or 232 of the Companies Ordinance (relating to the transfer of shares in a voluntary liquidation));
- an attachment, sequestration, distress or execution put into effect after commencement of the winding-up (Sections 183 (compulsory liquidation) and 269 of the Companies Ordinance); and
- extortionate credit transactions (Section 264B of the Companies Ordinance).

The corporate insolvency regime in Hong Kong, China currently does not recognise the concept of transactions at an undervalue.

7.4 What is the position of both unsecured and secured creditors that vote against, do not agree with or do not consent to either a formal or an informal rescue plan?

If creditors disagree with a proposed scheme of arrangement, they may vote against it at the court-convened meetings. However, if the necessary majority votes in favour of the scheme, dissenting creditors are bound by the scheme.

In an informal rescue, creditors retain their normal contractual rights and may pursue such remedies against the company at any time.

7.5 What actions can creditors take if they are not satisfied with the conduct of either a formal rescue procedure or a corporate bankruptcy/liquidation?

In a liquidation, if creditors are not satisfied with the liquidator's actions, then subject to certain rules they can require him to call a creditors' meeting or can take the dispute to court. The liquidator can be replaced under certain circumstances.

In a scheme of arrangement, minority creditors are bound by the majority. An objection to the specification of the classes of creditors used to hold meetings can be raised at the hearing for the petition to sanction the scheme.

8. General

8.1 Can the insolvency regime be described as systematic and efficient for:

(a) The liquidation of businesses incapable of being restructured?

Hong Kong, China is generally well regarded in terms of dealing efficiently and fairly with insolvent companies in liquidation.

(b) The restructuring of debt?

Other than having no statutory workout scheme, Hong Kong, China is also generally well regarded when it comes to restructuring of debt.

8.2 What are the biggest legal and non-legal impediments to the systematic and efficient liquidation of businesses and restructuring of debt?

Hong Kong, China is still awaiting the implementation of a statutory workout scheme. At present, restructuring of debt outside a liquidation/receivership/scheme of arrangement can be done by general consensus only. The absence of a formal procedure such as that proposed for provisional supervision means that small creditors can hold up the process indefinitely, although following the guidelines set out in "The Hong Kong Approach to Corporate Difficulties" when pursuing out-of-court restructurings means these difficulties are less common. The courts are also developing a practical solution by expanding the use of provisional liquidation for purposes of exploring a rescue (including through a scheme of arrangement).

Insolvency law in Hong Kong, China is currently fragmented, with provisions included in the Companies Ordinance, the Bankruptcy Ordinance and other legislation. As well as being more cumbersome to follow and apply, in some cases (eg, the meaning of 'associates' for unfair preferences) the various ordinances cross-reference each other but do not work seamlessly together, creating unanticipated uncertainties and gaps in application. It would be helpful – albeit a long-term project – if insolvency law in Hong Kong, China were consolidated into a single ordinance (and updated at the same time). One obvious and useful update would be to expand the concept of fraudulent trading by introducing, for example, a wider concept of insolvent or wrongful trading.

As in most jurisdictions, the availability of court time can affect the timely winding-up of a company, especially where there are numerous or complex outstanding legal issues. In the years following the Asian economic crisis in 1997, the courts had a very busy schedule of winding-up cases. In the past few years the backlog has eased somewhat and the wait is certainly no worse than in any other common law jurisdiction.

8.3 Has the insolvency regime been reformed in the last two years? If so:

(a) What are the reforms?

(b) Are the reforms being implemented so as to facilitate the systematic and efficient handling of corporate insolvency cases?

There have been no significant reforms in the past two years.

8.4 Are there any other legal or non-legal changes in the last two years that have impacted on the operation of the insolvency law regime?

There have been no significant changes in the past two years.

8.5 Is statistical information on insolvency cases and corporate insolvency published? If so, how? Is it easily and freely accessible?

Information is published by the Official Receiver's Office and is freely available at www.oro.gov.hk.

8.6 What is the most urgent reform required to facilitate the systematic and efficient handling of corporate insolvency cases (formal and informal)?

There is a need for a formal statutory workout scheme. There is a proposal for a statutory scheme known as provisional supervision, but while the new law has been drafted it has not yet been enacted.

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Founded in Hong Kong in 1851, Deacons is one of Asia's leading business law firms with a network of affiliated firms and offices comprising over 900 legal professionals. Deacons is one of the largest law firms in Hong Kong, China, with almost 50 partners and over 200 fee earners. Deacons is the first foreign law firm approved to establish three representative offices in mainland China, located in Beijing, Guangzhou and Shanghai.

With over 50 lawyers including six partners in Hong Kong, China, Deacons operates one of the largest integrated business recovery and insolvency practices in the Asia-Pacific region. Its team has a superb record of managing complex cross-border restructurings and insolvencies and recovering funds from debtors.

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