The corporate insolvency process in Hong Kong – key changes in 2016

The Companies (Winding Up and Miscellaneous Provisions) (Amendment) Ordinance 2016 (the Amendment Ordinance) introduces important changes in the way the winding up process is administered although it is not yet clear when the changes will come into force. In the second of two briefings examining the impact of the new legislation, we focus on the changes designed to improve the integrity of existing processes as opposed to implementing any radical reforms. We also ask whether the introduction of the somewhat limited new legislation represents a significant missed opportunity to modernise Hong Kong's antiquated corporate insolvency regime.

Overview

In our first briefing[1], we noted how the Government had said the aim of the new legislation was to "*improve and modernise Hong Kong's corporate winding-up regime by providing measures to increase protection of creditors and further enhance the integrity of the winding-up process.*"

Aims

The Amendment Ordinance tries to achieve its aims of better creditor protection with new provisions allowing the setting aside of transactions at an undervalue within five years of the winding up, rectifying the current law on unfair preferences (making it far more user friendly) and creating liabilities for directors and members to contribute to the assets of a company in connection with a redemption or buy-back of the company's own shares within one year of the winding up. The Amendment Ordinance also attempts to enhance the integrity of the winding up process itself, the focus of this briefing.

The winding up process

New safeguards in voluntary winding up

The Amendment Ordinance introduces safeguards which seek to reduce the risk of abuse by directors in a voluntary winding up. Under the existing section 228A (in place since 2003), if the directors have formed the opinion that the company cannot by reason of its liabilities continue its business, they may resolve at a meeting of directors to commence a voluntary winding up.

Key issues

- Changes to the winding up process are meant to improve integrity.
- The powers of liquidators nominated by company and directors are restricted.
- Liquidators can be pursued for misfeasance after discharge.
- Conflicts of interest must be declared.
- Hong Kong still lags behind other jurisdictions, notably Singapore, with its lack of a corporate rescue regime and no effective sanctions against delinquent directors.

The section can be useful in circumstances in which it is obvious the company is insolvent and creditors have started enforcement action, such that any delay to the winding up would upset the *pari*

[1] Clifford Chance Client Briefing June 2016: *Winding up and insolvency law in Hong Kong – key changes in 2016*

passu distribution of assets to its creditors.

According to the revised section 228A procedure, the directors must deliver a winding up statement to the Registrar and cause meetings of the members and creditors to take place no later than 28 days after delivery of the winding up statement. The directors must declare that the winding up should be commenced under the section 228A procedure because it would not be reasonably practicable to proceed under another section of the Companies (Winding Up and Miscellaneous Provisions) Ordinance, Cap 32 (CWUMPO).

Previously, the directors only had to appoint a provisional liquidator *"forthwith".* This procedure was open to potential abuse, giving unscrupulous directors an opportunity to appoint their own chosen liquidator without reference to the creditors and taking advantage of the "window" in a creditors' voluntary liquidation between the time of the members' meeting and the subsequent creditors' meeting. During this period, a liquidator appointed by the company at the behest of the directors might potentially act to the detriment of the creditors, such as selling the assets and business of the company at a knock down price to a connected party.

Such a practice was considered in the England and Wales case of *Re Centrebind Ltd* [1966] 3 All ER 889, which held that the acts of a liquidator appointed at a members' meeting are still valid even if and when the liquidator is removed at the subsequent creditors' meeting.

The changes under the Amendment Ordinance mean that the appointment of the provisional liquidator will commence upon delivery of the winding up statement to the Registrar ("*the commencement of the winding up"*) (amended section 228A, CWUMPO), thereby ensuring that directors cannot delay the appointment. Such a person must be either a solicitor or a certified public accountant (amended section 228A(8)(b), CWUMPO).

At this point, it is relevant to note that Hong Kong does not have a regulated insolvency profession and it can be strongly argued that this is of itself a deficiency which should be remedied.

Powers and duties of liquidator nominated by company

As a further protection, a person who is nominated by the company to be liquidator may only exercise limited powers without the sanction of the court. These include the power to take into custody the company's property and assets, dispose of perishable goods and take actions necessary to protect the company's assets (new section 243A, CWUMPO).

Directors' powers before nomination or appointment of liquidator

In a members' voluntary (ie solvent) winding up, the directors may exercise their powers only with the sanction of the court (new section 250A(1), CWUMPO) before the appointment of a liquidator.

In a creditors' voluntary winding up, the directors may only exercise their powers with the sanction of the court and as necessary for the purpose of enabling them to call a meeting of the creditors (new section 250A(2), CWUMPO).

In both situations, the directors may, without court sanction, dispose of perishable goods or do anything necessary to protect the company's assets.

Provisional liquidators

The Amendment Ordinance revises CWUMPO to set out more clearly the duties, basis for determining remuneration and tenure of the office of provisional liquidators in a court ordered winding up (amended section 193, CWUMPO).

New section 199B CWUMPO also sets out more clearly the statutory powers of provisional liquidators in a court ordered winding up. It provides a template for applicants to court to use, thereby seeking to avoid unnecessary customisation in individual applications.

Liquidators' liabilities

Section 276 CWUMPO presently provides that if it appears that any past or present liquidator of the company has become liable or accountable for any money or property of the company, or has been guilty of any misfeasance or breach of duty in relation to the company, the court may make orders to compel such person to repay or restore the money or property.

At present, however, the application of the section is limited by section 205 CWUMPO, which provides that once a liquidator has been validly discharged by the court and the company has been wound up, the liquidator is discharged from all liability in respect of any act done or default made in the administration of the affairs of the company or as liquidator.

The amended section 276 brings the liability limitation period of liquidators in line with other professional sectors, where liability is subject to the limitation period set out in the

Limitation Ordinance (Cap 347). Misfeasance is often only discovered after the grant of release. As well as being subject to the usual limitation periods, any moves to hold former liquidators accountable for past wrongs will require leave of the court to discourage frivolous litigation.

Some practitioners may feel this is unwelcome since many liquidations take place in a hurried atmosphere when urgent commercial decisions necessarily need to be made and which, it can be argued, should not be subject to a hindsight test.

Conflicts of interest

Provisional liquidators or liquidators with a conflict of interest will be disqualified from taking office except with the leave of the court. A person subject to a disqualification order will be barred from serving as a provisional liquidator or liquidator (new section 262B, CWUMPO).

Disclosure statement

Prospective provisional liquidators or liquidators will be required to make a disclosure statement, confirming they are not disqualified from taking up office and that they have no relationships that would present a conflict of interest (new sections 262C, 262D, CWUMPO).

Relationships that need to be declared include being a creditor or debtor of the company, holding company or its subsidiary, being a legal advisor or financial advisor of the company, its holding company or subsidiary. Failure to make adequate disclosure is an offence.

Removal and resignation of liquidator in voluntary winding up

New section 244A has been added to CWUMPO to specify the circumstances in which a liquidator may be removed. This can happen if not less than 10% in value of the creditors of a company request that a meeting of creditors be convened to consider the removal of a liquidator.

New section 154A CWUMPO sets out how the resignation of a liquidator in a creditors' voluntary winding up should be handled. The liquidator must summon a creditors' meeting which may then by resolution agree to accept the resignation.

Prohibition on inducement to secure appointment

The existing prohibition on offering an inducement to a member or creditor to secure appointment as liquidator is expanded to include an inducement offered to any person. The prohibition now extends to the appointment of provisional liquidators (amended section 278A, CWUMPO).

Private examination by the liquidator

New sections 286A to 286E have been added to CWUMPO with a view to improving the public examination procedures of promoters and directors. The sections codify the current common law position, whereby the right against self-incrimination is abrogated (new section 286D, CWUMPO).

Committees of Inspection

The Amendment Ordinance contains provisions prescribing the maximum and minimum numbers of members of committees of inspection (COIs) (amended sections 206 and 243, CWUMPO), amending CWUMPO to streamline and rationalise the proceedings of COIs (new section 206A, amended section 207 CWUMPO), allowing for remote attendance at COI meetings (new section 207B, CWUMPO) and enabling a COI to make decisions through written resolutions (new section 207D, CWUMPO).

A member of a COI may, in relation to the business of the committee, be represented by a person authorised by the member for that purpose (new section 207A, CWUMPO).

Timescale

The Amendment Ordinance will come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury. Currently, there is no public information as to when this will be or if the changes will be introduced in stages.

An opportunity missed?

As discussed in our first briefing, the Amendment Ordinance does not include provisions relating to corporate rescue or to delinquent directors. These are areas where Hong Kong's corporate insolvency regime has for some considerable time lagged behind other jurisdictions within the region (most notably Singapore) and internationally, such as England and Wales.

At present, provisional liquidation is often used as a tool for implementing a corporate rescue. Under this procedure, a winding up petition is made to the court; the petitioner may then request the court to appoint a provisional liquidator solely at the court's discretion and requiring a need to demonstrate that assets are "in jeopardy". The petitioner or the provisional liquidators then request the court to adjourn the petition hearing to give time to the provisional liquidator to propose a scheme of arrangement with the creditors of the insolvent company. If the scheme of arrangement is sanctioned, the

winding up petition is withdrawn, failing which the court will grant a winding up order.

This "make do" solution is far from ideal and is often seen as a sledgehammer to crack a nut. There are limits on the provisional liquidators' powers as well as close court supervision.

It is now 30 years since the UK Insolvency Act 1986 (and subsequently amended) radically overhauled UK insolvency law (then very similar to Hong Kong law) by introducing the corporate rescue procedure of administration, the company voluntary arrangement procedure and "wrongful trading" under which, in certain prescribed circumstances, directors of an insolvent company can be personally liable for the debts of the company. A statutory director disqualification regime was also introduced at the same time. It is noteworthy that no such important changes have yet to be made to Hong Kong's insolvency law.

Comparison with Singapore

On a more local basis, the position in Hong Kong also contrasts markedly with that of Singapore in terms of the existing regime, but also potential legislative changes.

In Singapore, the existing regime offers judicial management as a corporate rescue tool and a moratorium for directors promoting a scheme of arrangement outside of any form of insolvency process. Moreover, Singapore now proposes to establish itself as a leading centre for international debt restructuring through proposed enhancements to its corporate rescue mechanism.[2] In summary, it is being proposed that the scope of the Singapore courts' jurisdiction over foreign corporate debtors be extended, the statutory moratorium applicable upon the commencement of a relevant insolvency process should be extended (so that it more closely resembles the stay of proceedings mechanism under Chapter 11 of the US Bankruptcy Code), and that consideration be given both to the establishment of a specialist insolvency court and to the introduction of priority rescue financing within a corporate restructuring context.

Meanwhile in Hong Kong, while the Government has said it is developing detailed proposals on corporate rescue, the practical reality is that such proposals have been in the offing since the time of the Asian financial crisis and that despite various consultation processes, nothing substantive has yet been forthcoming.

Whilst the primary aim of our two briefings has been to highlight the key changes which are to be introduced into Hong Kong corporate insolvency law, it is a real concern that Hong Kong's corporate insolvency laws and procedures are not currently fit for purpose. In the evolving world of cross border insolvency and forum shopping, there must be a risk that Hong Kong itself will be the loser.

---

[2] Clifford Chance Client Briefing May 2016: *Singapore: The push to become Asia Pacific's leading centre for debt restructuring*

Contacts

Scott Bache
Partner

T: + 852 2826 3493
E: Scott.Bache
@CliffordChance.com

Mark Hyde
Partner

T: + 852 2825 8855
E: Mark.Hyde
@CliffordChance.com

Donna Wacker
Partner

T: + 852 2826 3478
E: Donna.Wacker
@CliffordChance.com

Joanna Charter
Consultant

T: + 852 2826 2458
E: Joanna.Charter
@CliffordChance.com

Jonathan Denniss
Senior Associate

T: + 852 2826 2487
E: Jonathan.Denniss
@CliffordChance.com

Phoebe Lo
Associate

T: + 852 2826 3465
E: Phoebe.Lo
@CliffordChance.com

Clifford Chance, 27th Floor, Jardine House, One Connaught Place, Hong Kong

www.cliffordchance.com