

TOWARDS AN EFFECTIVE SCHEME-BASED CORPORATE RESCUE SYSTEM FOR HONG KONG

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A. INTRODUCTION

The debate over corporate rescue towards the end of the last century has largely dismissed the Scheme of Arrangement (SOA) as a viable reorganisation device¹. According to its critics, SOA is not up to the job of effecting successful corporate rescues because the procedure is complex and expensive to use, and, to make the matters worse, it does not involve a moratorium.² This negative assessment of SOA has however not been confirmed by history.

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¹ D Milman, "Scheme of Arrangement and Other Restructuring Regimes under UK Company Law in Context" (2011) 301 *Co L N* 1. For the meaning of corporate rescue, see V Finch, *Corporate Insolvency Law: Perspectives and Principles* (CUP 2nd edn, 2009), 243-244; R Parry, *Corporate Rescue* (London, Thomson Sweet & Maxwell, 2008), 2. The term "corporate rescue" is however used in this article to mean not only saving the company as a going concern but also (i) "[a] more advantageous realisation of the company's property than would be effected on a winding up of the company" and (ii) the more advantageous satisfaction, in whole or in part, of the debts and other liabilities of the company", which are among the stated purposes in the corporate rescue procedure (Provisional Supervision) proposed for Hong Kong: Financial Services and the Treasury Bureau, *Review of Corporate Rescue Procedure Legislative Proposals: Consultation Paper* (Hong Kong, Oct 2009), 2-3.

² The UK SOA provision (Companies Act 2006, s 895) does not provide for a moratorium. Nor does Hong Kong's equivalent provision (Companies Ordinance, s 166), which is of British lineage: EL Tyler (ed), *Hong Kong Company Law Handbook* (Hong Kong, LexisNexis, 11th edn, 2009), 757-758. For views on SOA as a rescue procedure see: Finch, *supra*, n 1, , 483; E L Tyler, "Proposals for a New Corporate Rescue Procedure in Hong Kong" in G Wang & Z Wei (eds), *Legal Developments in China: Market Economy and Law* (Hong Kong, Sweet & Maxwell Asia, 1996), 55-56; S Smith, "Some Problems in Reorganising Insolvent Companies" in M Merry (ed), *Law Lectures for Practitioners* (1983) accessed on 12 Aug, 2011: <http://sunzi.lib.hku.hk/hkjo/article.jsp?book=14&issue=140006>, 245; P Smart & CD Booth, "Reforming Corporate Rescue procedures in Hong Kong" (2001) 1 *Journal of Corporate Law Studies* 485, 487 ("the deficiency of the scheme of arrangement as a corporate rescue mechanism require no elaboration"); CD Booth, "Hong Kong insolvency law reform: preparation for the next millennium" (2001) *The Journal of*

The experience in Hong Kong, which does not have a purpose-built reorganisation regime, demonstrates that SOA can be used effectively as a reorganisation device.

In Hong Kong, formal corporate reorganisations can be effected only through the SOA-based alternative formal rescue system (the SOA system). The SOA system has emerged in Hong Kong for at least two reasons. The first is the need for a formal rescue procedure, which started to be keenly felt in the mid-late 1990s. The second is the difficulties in the enactment of a corporate rescue procedure in Hong Kong. The government made an attempt in the early 2000s to introduce, without success, a corporate rescue procedure called Provisional Supervision (PS).³ The bottleneck that led to the failure to introduce PS was, in essence, that the proposed procedure could not be opened without paying a premium to the company's employees to be laid off over and above their statutory preferential entitlements.⁴

Perhaps due to the common perception of the utility of SOA as a rescue instrument and the fact that the focus of critics' attention has mostly been on the formulation of a purpose-built rescue procedure,⁵ there appears to be a gap in the literature on SOA as a rescue procedure used in Hong Kong.⁶ The likelihood that the SOA system will remain the only or preferred

Business Law 126, 147-148; CD Booth, et al, "Corporate Rescue in Hong Kong" in R Olivares-Caminal (ed), *Expedited Debt Restructuring: An International Comparative Analysis* (The Hague, Kluwer Law International, 2007), 297, 301. See also DG Baird, *Elements of Bankruptcy* (Washington DC, BeardBook, 5th edn, 2010), 237; LM LoPucki & GG Triantis, "A System Approach to Comparing US and Canadian Reorganization of Financially Distressed Companies" in J S Ziegel (ed), *Current Developments in International Comparative Corporate Insolvency Law* (Oxford, Clarendon Press, 1994), 109, 163, 171. Note, however, that the SOA provisions in jurisdictions where this procedure is of Australian lineage does provide for an interim moratorium: see n 192 below.

³ See *infra* Part C.

⁴ *Infra* text to n 35.

⁵ For example, Tyler, *supra* n 2; Smart and Booth (J Corp L Stud), *supra* n 2; Smart and Booth, (HKLJ), *supra* n 2; CD Booth, "Hong Kong Insolvency Law Reform: Preparing for the Next Millennium" (2001 March Issue) *Journal of Business Law* 126; ELTyler, "Insolvency Law in Hong Kong" in Roman Tomasic (ed) *Insolvency Law in East Asia* (Aldershot, Ashgate, 2006), 213; CD Booth and TN Lain, "Rescuing Hong Kong Companies with Provisional Supervision: Proposals that Workers and Management can Support" (2010) 40 *Hong Kong Law Journal* 271.

⁶ Although there is a small body of literature on SOA as a rescue device in Singapore, little has been done on Hong Kong's SOA-based rescue system. For literature on SOA in Singapore, see LE Beng, "Recent developments in insolvency laws and business rehabilitations – national and cross-borders issues" accessed on 12 Aug 2011: http://www.aseanlawassociation.org/docs/w6_sing.pdf; TE Chan, "Schemes of Arrangement as a Corporate Rescue Mechanism: The Singapore Experience" (2009) 18 *International Insolvency Review* 37. For a

formal reorganisation procedure in Hong Kong in the near future, however, calls for clarification of the extent to which this system is able to function as a formal reorganisation regime and consideration on the ways in which the inadequacies of the system can be remedied.

This article proposes to assess the quality of the SOA system in the light of the intended functions of a formal reorganisation system and to make proposals on the ways in which the effectiveness and utility of the system can be improved. The quality of the system will be assessed according to its ability to perform the three key functions of a formal rescue regime, namely, (i) to encourage the debtor's early entry into reorganisation in appropriate circumstances, (ii) to achieve a decision on the deployment of the debtor's assets (the allocational decision) undistorted by opportunistic behaviours on the part of pre-petition management and other stakeholders, and (iii) to provide a moratorium during which a rescue

recent article on the utility SOA as a restructuring device in the UK, see D Milman, "Schemes of Arrangement and other Restructuring Regimes under UK Company Law in Context" (2011) 301 *Co L N* 1.

plan can be considered or devised.⁷ The assessment will be conducted in the light of 53 case decisions relating to the operation of SOA as a rescue instrument.⁸

The result of the assessment demonstrates that on the whole, the SOA system, through its flexible reorganisation power allocation and collective decision-making mechanisms, as well as its court-led stay device, has done an effective job in performing the abovementioned corporate rescue functions. The paper will however point out that the efficacy of the SOA system can be greatly improved if the existing stay process is streamlined through linking a court-controlled moratorium to the SOA provision.

The remainder of the article will proceed as follows. Section B considers the need for a formal reorganisation regime in Hong Kong. Section C proceeds to discuss the proposed PS procedure and the bottleneck that prevents it from being enacted or used as a preferred rescue procedure. Sections D to G examine the reasons for the emergence of the SOA system and the ways in which the system performs the functions of a formal restructuring system.

⁷ Triantis identifies a number of the “cornerstones” of a reorganisation regime (G Triantis, “Mitigating the Collective Action Problem of Debt Enforcement through Bankruptcy Law: Bill C-22 and its Shadow” (1992) 20 *Canadian Business Law Journal* 246, 248 - 249). One of these is “provisions that preserve and maximise the going-concern surplus of the business during the reorganisation process”. The debtor’s timely commencement of the reorganisation process is crucial to the preservation of its going concern value premium (D Hahn, “Concentrated Ownership and Control of Corporate Reorganisations” (2004) 4 *J Corp L Stud* 117, 139). The ultimate purpose of any corporate insolvency regime is to reallocate the assets of uncompetitive entities (Armin, J Kammel, “The Law and Economics of Corporate Insolvency – Some Thoughts” in P J Omar (ed), *International Insolvency Law: Themes and Perspectives* (Aldershot, Ashgate, 2008) 61-62). A rapid redeployment of the assets of inefficient firms to higher value uses is conducive to economic growth and helps maximize the resources available for the payment of creditors’ claims (K E Davis & M J Trebilcock, “Legal Reforms and Development” (Feb 2001) *Third World Quarterly* 21, 21-23). A decision made by pre-petition management and creditors on the deployment of the debtor’s assets can however be distorted by the stakeholders’ strategic behaviour ((J Armour, *The Law and Economics of Corporate Insolvency: A review*, accessed on 7 October 2011: <http://www.cbr.cam.ac.uk/pdf/wp197.pdf>; J J Quinn, “Corporate Reorganisation and Strategic Behaviour: An Economic Analysis of Canadian Insolvency Law and Recent Proposals for Reform” (1985) 23 *Osgoode Hall LJ* 1; Hahn: *ibid*). A central task of a corporate reorganization project is therefore to correctly identify the higher value uses and determine how the debtor’s assets should be allocated accordingly. To combat creditors’ hold-out’ behaviour and to prevent the company from dismembered by individual enforcement actions, it is imperative for any reorganisation regime to provide for a stay of proceedings (Triantis: *ibid*)).

⁸ See Appendix I. These cases, which were decided between 1989 and 2009, are collected from the Hong Kong Collection of the Westlaw International database. Some of these decisions relate to different aspects of using SOA as a rescue procedure with regard to the same matter (e.g. decisions on the initial and subsequent adjournment applications and on the petition for the sanction of the proposed scheme).

Section H debates the ways in which the existing stay mechanism can be reformed to improve the overall effectiveness of the SOA system.

B. THE NEED FOR A FORMAL CORPORATE RESCUE PROCEDURE IN HONG KONG

Historically, the failure rate of companies incorporated in Hong Kong has been low. Research shows that in the late 1980s liquidation figures in Hong Kong were proportionately less than half those in the United Kingdom.⁹ Prior to the 1997 Asian Financial Crisis (AFC), restructuring and reorganisation in Hong Kong were relatively few and far between.¹⁰ Until the mid 1990s, financial lenders in Hong Kong were quite resolute in enforcing their rights when dealing with delinquent debts and were generally able to realise the debtor's businesses or assets at fairly good prices. Large insolvency cases involving listed companies were relatively uncommon and financial lenders were only willing to be involved in restructuring negotiations in significant cases.¹¹ Naturally, there was less concern in Hong Kong about the need for a corporate rescue regime.

This attitude towards restructuring or reorganisation changed when a large number of third or fourth tier companies were permitted to be listed on the Hong Kong Stock Exchange between 1993 and 1997. Many of these companies, which barely had enough assets or track records to be listed on the market, were highly geared but banks generally were unable to obtain charges

⁹ EL Tyler, "Current Issues in Insolvency" in *Commercial Law* (1991) 20-22; Tyler, *supra*, n 2 (Legal Development in China, 52. The likely reasons included the *Draconian* debt enforcement procedures (both legal and extra-legal), the flexibility of Hong Kong Chinese businesses, and extended family financing and support: Tyler: *id*.

¹⁰ AC Tang, *Insolvency in China and Hong Kong* (Hong Kong, Thomson Sweet & Maxwell Asia, 2005), 35.

¹¹ *Ibid*.

(especially floating charges) over the assets of this type of debtor, as they were listed companies and the debtors tended to have multiple lenders.¹²

During the AFC, the market sentiment in Hong Kong was at a historic low. This, when coupled with the vulnerability of the abovementioned category of listed companies to adverse economic changes and the weakened ability of banks to enforce their right as lenders, ushered in an era during which restructuring became a commonly used alternative to liquidation procedures.¹³

It is possible in Hong Kong, as in many other jurisdictions, to rescue the debtor company through a workout.¹⁴ It is also well known that a receiver and manager may be able to trade the debtor out of financial trouble or rescue the debtor's business by realising the company's business as a going concern through different techniques, such as a "hive down".¹⁵ When receivership is used as a private law remedy, a receiver can be appointed by a secured lender.¹⁶ The basic role of a receiver is to collect, protect and receive property and income from the charged property. A receiver may also be given the power to sell the security and parts of the charged property.¹⁷ Where the charge is over the entire business and undertaking, the receiver may be given the power to carry on the business, in which case the receiver is called a receiver and manager.

¹² Ibid.

¹³ Ibid.

¹⁴ A workout is "[a]n out of court agreement between the stakeholders of a company on a mutually acceptable course of action, with the aim of rescuing an enterprise with a commercially viable future": Subhrendu Chatterji and P Hedges, *Loan Workouts and Debts for Equity Swaps* (Chichester, John Wiley & Sons, 2001), 21.

¹⁵ "By this method, a new subsidiary is formed and the assets of a viable business (including current contracts) are transferred to it for valuation. The shares of the subsidiary are then sold to a purchaser who thus takes over the new hive-down company free of the burden of the earlier liabilities. The insolvent company receives the consideration, which may represent a better and speedier realisation of assets for the benefit of the ordinary creditors than a break up sale of assets.": A Hick, "Reforming Insolvency Law – Company Rescues" (1986) 7 *Singapore Law Review* 128, 132. On the use of the hive down technique by a receiver to effect a corporate rescue see J Brewer, *The Law and Practice of Hong Kong Companies* (Hong Kong, Thomson Sweet & Maxwell, 2nd edn, 2009) 296-297 and Tyler, *supra*, n 2 (Hong Kong Company Law Handbook), 1262.

¹⁶ The Hon. Madam Justice Kwan et al (ed), *Company Law in Hong Kong – Insolvency Part 11 Receivership* (2005, loose-leaf) 11.001.

¹⁷ Tyler, *supra*, n 2 (Hong Kong Company Law Handbook), 1262 *et seq.*

The assistance that workouts and receivership can lend in corporate restructuring in Hong Kong, as compared to some other jurisdictions, may be more limited. Apart from the hold out problem identified in the literature,¹⁸ the fact that Hong Kong corporate borrowers tend to have multiple lenders, some of whom are based overseas, also constitutes an obstacle to achieving a rescue through workouts.¹⁹ It can be costly and very difficult to coordinate creditors to achieve a proposed workout.²⁰ The same fact also means that it may be difficult for a single lender to secure a floating charge, or, for that matter, a number of different fixed charges, over the whole, or substantially the whole, of the debtor's assets. As the obtaining of a charge or charges of this nature is a precondition for the appointment of a receiver and

¹⁸ For example, Triantis (n 7).

¹⁹ An example of a debtor company that has a large number of creditors is C P Pokphand. That company, which was reorganised in the 1990s, had more than 250 creditors (Interview with Mr Stephen Briscoe, Managing Director, Briscoe & Wong Ltd, , 29 September, 2010, Hong Kong).

²⁰ There is evidence in the UK that it is possible to reduce the coordination problem in cases where workouts are conducted under the so called "London Approach", which is a set of self-enforcing informal reorganisation conventions (J Armour and S Deakin, "Norms in Private Insolvency: the "London Approach" to the Resolution of Financial Distress" (2001) 1 *J Corp L Stud* 21). In fact, London Approach has been adopted in Hong Kong. In November 1999, the Hong Kong Association of Banks (HKAB) and the Hong Kong Monetary Authority (HKMA) jointly issued a non-statutory guideline called "Hong Kong Approach to Corporate Difficulties" (The Hong Kong Approach Guidelines). In terms of the way in which it works, the Hong Kong Approach is similar to the London Approach (see D Carse, *Speech in the Seminar on Hong Kong Approach to Corporate Difficulties*, 29 November 1999, http://www.info.gov.hk/hkma/eng/speeches/speeches/david/speech_291199b.htm, accessed on 9 October 2011). The role of the Hong Kong Approach in facilitating workouts in Hong Kong, however, appears to be limited. First, the number and diversity of banks involved in some workouts means that it can be extremely difficult to achieve consensus on restructuring proposals. In Hong Kong, it is not unusual to find even medium sized companies with dozens of lenders. Troubled companies may find it difficult to maintain the loyalty and support of all of their banks. Lenders that do not have long-term relationships with companies may try and protect themselves by pulling the line at the first sign of trouble (ibid). Also, a number of foreign banks began to reduce their commitment to Hong Kong since the late 1990s. Some of these banks tend to take a hard line and head offices of these companies, which may not be located in Hong Kong (and hence will pay less heed to the conventions established by the Hong Kong Approach), sometimes encourage this attitude (ibid). Second, the Hong Kong Approach guidelines only apply to bank lenders but in Hong Kong an ailing company often have a considerable number of non-bank creditors, especially where the company is in the construction sector (Booth et al (n 2) 311). Finally, markets for distressed debts may have destabilising consequences for the norms that have established by the London Approach (hence Hong Kong Approach), as "vulture" investors are less likely to repeat business with bank lenders in question (Armour and Deakin (ibid) 48, 49). Such markets have developed in Hong Kong and there is evidence on the pattern of behaviour of "vulture" investors that Armour and Deakin have described. In *Re Legend International Resorts Ltd* [2005] 3 HKLRD 16 CFI, for example, a Morgan Stanley vulture fund purchased the participation of a financial institution creditor in September 2004 and then proceeded to apply for the winding up of the debtor, which was a Hong Kong company the assets and operations of which are in the Philippines. Subsequent to the presentation of the petition, the vulture fund acquired the entire participation of a consortium of lenders. When the company petitioned for corporate rehabilitation in the Philippines, the vulture fund investor applied for the appointment of a provisional liquidator in Hong Kong, contending that the Philippine court did not have jurisdiction to entertain the Rehab petition. The vulture investor in this case obviously did not pay any heed to the Hong Kong Approach guidelines.

manager,²¹ the difficulty for a lender to obtain charges may limit the utility of receivership as a rescue device in Hong Kong.²²

C. THE RESPONSE OF THE HONG KONG GOVERNMENT: THE PROPOSED PROVISIONAL SUPERVISION PROCEDURE

In fact, the need for a rescue regime was felt in Hong Kong even some years before the 1997 AFC. In September 1990, the Attorney General and the Chief Justice of Hong Kong instructed the Law Reform Commission of Hong Kong (LRC) to conduct a thorough review of insolvency law. This move was prompted by the publicity of the corporate turnarounds during the mid-1980s shipping slump, when a number of large shipping groups (including Hutchison Whampoa Ltd, Wah Kwong Shipping and Investment Company (Hong Kong) Ltd and Oriental Overseas Holdings Ltd) almost collapsed due to the world-wide downturn in the shipping industry in the early 1980s.²³ One of the topics under review was the desirability of enacting a corporate rescue procedure. The LRC established a sub-committee to research this topic.²⁴ In June 1995, the sub-committee published its *Consultation Paper on Corporate Rescue and Insolvent Trading*. In October 1996, the LRC published its *Report on Corporate Rescue and Insolvent Trading*, which contained its proposal on PS. The proposal was made after a thorough review of, among other things, the corporate rescue or reorganisation procedures adopted by some major common law jurisdictions as well as the existing statutory means through which a financially stressed company can reach a compromise with its

²¹ R Goode, *Principles of Corporate Insolvency Law* (London, 3rd edn, Thomson Sweet & Maxwell, , 3rd edn, 2005), 247-248.

²² Although receivership is by no means useless for corporate rescue in Hong Kong. This is evidenced in the cases where SOA rescue schemes are organised by receivers and managers appointed to the debtor: *Re X10 Ltd* [1989] HKLY 108; *Re Interform Ceramics Technologies Ltd* [2001] HKEC 469; *Re S Megga Telecommunications Ltd* [2002] HKEC 1344; *Re Music Trading On-Line (HK) Ltd* [2008] HKEC 2110.

²³ See Tyler, *supra*, n 2 (*Legal Development in China*) 51, 56; Tang *supra*, n 10, 63-90.

²⁴ Tyler, *supra*, n 2, (*Legal Development in China*) 57.

creditors. The LRC noted that it was possible for a debtor company to achieve a compromise with its creditors through the arrangement provisions under s 166 of the Companies Ordinance (CO). The LRC, however, believed that it was necessary to propose a purpose-built rescue procedure as s 166, when used as a rescue procedure, suffered from a number of deficiencies. The inadequacies that the LRC has identified include the lack of a stay mechanism, the costs associated with court appearances, and the lack of the ability to provide for the smooth transition to voluntary arrangement or winding up.²⁵

Under the 1996 LRC proposal, the PS procedure was to be triggered by the appointment of a provisional supervisor, who was an independent insolvency specialist. This appointment was to be made by directors. A ‘major secured creditor’ (i.e., a creditor holding a fixed charge or a floating charging over the whole or substantially the whole assets of the company) had the right to veto a proposed provisional supervision.

Once appointed, the provisional supervisor was to take over the management of the company from the directors. The appointment of a provisional supervisor would automatically trigger a 30-day moratorium, which could be extended to six months by the court. During the moratorium, the provisional supervisor was to make a judgment on the viability of having the company rescued or restructured. If the conclusion was in the negative, the company would go into liquidation. In case the provisional supervisor believed the company was salvageable, he or she was to prepare a voluntary arrangement plan (which is a rescue proposal). The arrangement plan must be approved by a vote of majority in number and 75% in value of creditors present who would vote in one single class. Once the arrangement plan was approved, it would become binding on the company and all of its creditors. The provisional supervisor was, at this point, to hand the power of management back to the directors.

²⁵ The Law Reform Commission of Hong Kong, *Report on Corporate Rescue and Insolvent Trading* (October 1996) [1.1] – [1.7].

To facilitate the availability of working capital for a proposed rescue, the procedure made a provision for ‘super priority’. Under this provision, a lender which was willing to provide funding after the commencement of the provisional supervision was given priority over all other claims, with the exception of fixed charges.

To give effect to the above-mentioned LRC recommendation, legislation was introduced in January 2000 in the form of Companies (Amendment) Bill 2000. This Bill met strong resistance from stakeholders. The main reason for the staunch opposition was that it contained a requirement that before the company could go into PS, it must discharge all of its obligations to workers (such as unpaid wages and other entitlements due under the Employment Ordinance (Cap 57)) or set up a trust with sufficient funds to meet this payment obligation.²⁶ A company in need of rescue would not have the cash to meet these payment requirements. The clauses on PS were therefore excised from the Bill in April 2000.

The reason why stakeholders were so firm about the full payment requirement was that Hong Kong Government only offers very limited social security benefits and there is no full unemployment benefit.²⁷ The real protection of the workers is derived from the Protection of Wages on Insolvency Fund (PWIF), which was established under the Protection of Wages on Insolvency Ordinance 1985 (PWIO). Under the PWIO, the PWIF is to be provided through a levy payable by every business registered in Hong Kong. The fund provides for the payment of a specific sum for arrears of wages, wages in lieu of notice and severance payment when a corporate employer is liquidated or a non-corporate employer becomes bankrupt. When the

²⁶ See Tyler, *supra*, n 5 (Insolvency Law in Hong Kong), 222; Booth and Lain, *supra* n 5, 272.

²⁷ EL Tyler and A Young, “Provisional Supervision in Hong Kong: Third Time Lucky?” (2011) 8 *International Corporate Rescue* accessed on 12 Aug 2011: <http://www.chaseCambria.com/site/journal/icr.php?vol=9&issue=1>; Anonymous, “Proposed Trust Fund Cause for Concern”, *South China Morning Post*, 12 Dec 2001, p 7. The government only provides able-bodied unemployed persons aged between 15 and 59 with employment assistance and very modest temporary financial assistance. For details see http://www.swd.gov.hk/en/index/site_pubsvc/page_socsecu/sub_comprehens/.

payment is made, the PWIF is subrogated to the employees' preferential rights under s 265 of the CO or s 38 of the Bankruptcy Ordinance (BO). The payment is to be *ex gratia*.

The effect of the PWIO and PWIF is that employees whose positions have been terminated *when the company is wound-up* can receive more favourable treatment than under the CO or BO, where they are treated as preferential creditors.²⁸ To apply for a PWIF payment, a winding-up petition must have been made against the employer company. Where the company enters into PS, such a petition may not have been made, in which case the employees are not entitled to PWIF payments. To ensure the protection of employees laid off during PS, the LRC's 1996 proposals recommend that PS should be an additional triggering event of payment out of the PWIF.²⁹ This proposal was, however, strongly resisted by various stakeholders for various reasons, one of which is that treating PS as a triggering event of PWIF payments would enable unscrupulous employers to misuse PS and shift their employee payment obligations to PWIF.³⁰ The full payment requirement under the 2000 Bill was proposed as an alternative to the 1996 LRC PWIF payment proposal.³¹

A second attempt of introducing the PS legislation to the Legislative Council was made in 2001. The 2001 Bill, entitled Companies (Corporate Rescue) Bill, amended the 2000 Bill in relation to the protection of secured creditors, but the clause on the company's obligations to employees was substantially unchanged. Again, the Bill failed to gain support from stakeholders, who believed that priority treatment of employees' entitlements would mean that PS would rarely, if ever, be used. The Bill was allowed to lapse.³²

²⁸ The amount of PWIF payment that an employee is entitled to is several times larger than their preferential entitlement: for details see Tang, *supra*, n 10, 461.

²⁹ The Law Reform Commission of Hong Kong, *supra*, n 25, [5.40] – [5.43].

³⁰ P Smart, "Reforming Corporate Rescue Procedures in Hong Kong" (2001) 1 *Journal of Corporate Law Studies* 485, 495.

³¹ Companies (Amendment) Bill 2000, s 168ZA (c) (iv); P Smart and CDBooth, "Provisional Supervision and Workers' Wages: An Alternative Proposal" (2001) 31 *Hong Kong Law Journal* 188, 189.

³² Tyler and Young, *supra*, n 27.

A subsequent proposal was made by the Hong Kong Government to the Legislative Council in 2003 (the 2003 proposal). This proposal recommended a cap on the amount payable to employees when the company was compulsorily wound up to the equivalent amounts payable to workers by PWIF (HK\$278,500) before it could enter into PS.³³ No action, however, has been taken to implement this recommendation.

In the late 2009, prompted by the recent global financial crisis, the Task Force on Economic Challenges assembled by the Hong Kong Government recommended that PS be reintroduced. A three-month public consultation organised by the Hong Kong Government on the review of the proposed rescue procedure concluded in June 2010.

Whilst the proposals made in the “Consultation Conclusions” contain some improvements on the previous version of the PS procedure, the bottleneck of PS (i.e., the employee priority treatment problem) remains unbroken. Under the proposals made in the Consultation Conclusions on this topic (the final proposals), the company must pay arrears of wages up to the PWIF limit by the 30th calendar day after the commencement of the procedure. Outstanding entitlements (pay-in-lieu of notice and severance payment) of the workers who have been laid off before the commencement of PS must be paid up to the PWIF limit 45 calendar days after the voluntary arrangement has been approved. If the initial moratorium period is extended, the payment must be made with 45 calendar days from the date of extension. Any remaining outstanding pre-commencement entitlements must be paid in full within 12 months after the voluntary arrangement has come into effect.³⁴ If the company fails to make payment according to the timetable, the employees will be able to present a petition to the court to wind up the company.

³³ See http://www.legco.gov.hk/yr00-01/english/bc/bc12/papers/bc12cb1-2185-1_e.pdf.

³⁴ Financial Services and the Treasure Bureau, Hong Kong SAR, “Review of Corporate Rescue Procedure Legislative Proposals: Consultation Conclusions” available at http://www.fstb.gov.hk/fsb/topical/review_crplp.htm, 15-16.

When compared to the 2003 proposals, the final proposals are more acceptable from the company's point of view. It is now at least possible to commence PS *before* any obligations to employees are discharged. However, for a company in a rescue situation, finding money to make salary payments to workers within 30 after the commencement of PS and other payments 45 calendar days, after the approval of the voluntary arrangement is still a tall order. The revised requirement of employee priority treatment, in other words, still makes the use of PS difficult.³⁵

³⁵ This appears to be the view of most of insolvency and restructuring professionals who made a submission to Hong Kong's Financial Services and Treasury Bureau (FSTB) in response to the FSTB's Consultation Paper on Review of Corporate Rescue Procedure Legislation Proposals available at http://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp/Anonymous%20D.pdf. See for example the submissions by Borrelli Walsh (an experienced specialist insolvency and restructuring firm) ("The alternatives put forward in the Consultation Paper will (both) unreasonably restrict the use of provisional supervision where a company, [sic] in financial distress has difficulty in finding sufficient cash to settle employees outstanding claims or may divert cash which may best be used to ensure the continuation of the business as a going concern"), Ferrier Hodgson ("Companies in financial difficulties are unlikely to have sufficient cash available to pay or meet such entitlements. Given the proposed insolvent trading amendments, what does a company do if it cannot pay these entitlements before entering into PS? It will have no alternative than to seek liquidation when it could not possibly be otherwise saved by PS"), K K Yeung Management (an experienced workout specialist) ("We would not prefer any of the three options namely the 2003 Proposal, Alternative A or Alternative B. We consider all the options to be unduly complicated and to a large extent, impracticable. Also, we consider that public funds like PWIF should not be used outside their currently established purposes for which the funds were set up"), Deloitte ("[U]nder this proposal, the possibility of rescuing the company will still be subject to the risk that the company may not have sufficient cash flow to settle the employees' outstanding entitlements"), William M F Wong (a barrister practising in the area of corporate insolvency) ("[A]lthough one is inclined to support an option that will grant full payment to employees albeit within 12 months, the reality... is that if Alternative B (the alternative that has been recommended in the Consultation Conclusion) is implemented, investors or white knights will simply buy out all the assets of the company at a certain price instead of taking over the company as a whole. They will then offer new contracts to the existing employees. ... To be pragmatic, one must realise that to insist on full payment to employees' outstanding claims may not be beneficial both to the underlying objective of corporate rescue and the interest of employee (emphasis original)."), Rupert Purser (a shareholder and director of a private equity fund that invests in distressed companies) ("However, if employees are to be paid ...a preferential amount that does not reflect a strict liquidation right of payment in accordance to a company's available assets that would be available to a liquidator, then the Government should provide funding for these payments."), See also the view of Briscoe Wong Ferrier (one of the most respected insolvency firms in Hong Kong): "Provisional Supervision And (More Importantly) Insolvent Trading" available at <http://www.briscoewongferrier.com/web/?p=468> ("The problem continues to be, how can a company that is hopelessly insolvent come up with sufficient cash to meet employee liabilities, particularly those which have to be paid under (1) and (2) above, within such a tight timeframe. This is likely to limit the use of the legislation, as many companies will not have the funds available to satisfy these requirements. In those cases, the outcome is likely to be liquidation and the loss of jobs rather than the company being rescued.") Business owners appear to share the views of insolvency professionals. For example, Hong Kong Small and Medium Enterprises Association has also expressed its concerns, in its submission to FSTB, on the need to make full payments to employees, pointing out that the very reason that some firms chooses to wind up is precisely its inability to discharge their debts to employee creditors.

D. THE EMERGENCE OF SCHEME OF ARRANGEMENT BASED RESCUE SYSTEM

The need for a formal reorganisation regime and the government's inability to uncork the bottleneck in PS has created a need for the courts to develop an alternative corporate rescue system on the basis of existing corporate and insolvency law framework. The centrepiece of this alternative rescue system is s 166 of the CO, Hong Kong's SOA provision. An SOA is a statutorily provided collective decision-making procedure through which the company, its shareholders, and its creditors may reach an agreement on the reorganisation of the rights and liabilities of a company's shareholders and creditors. The aim of an SOA is to obtain a binding agreement among stakeholders, through the operation of a majority rule, on the modification of the legal rights of shareholders and/or creditors. Such modification may or may not be detrimental to the right holder. An SOA can be organised for different purposes, such as effecting a capital reduction or redomiciling a company overseas, or reaching a settlement between the company and its creditors.³⁶ Section 166 constitutes an essential element of the SOA system because it facilitates a compromise between the company and stakeholders and stakeholders *inter se*. A basic step in a reorganisation process is the creditors' approval of the restructuring plan prepared by the person in charge of the proposed reorganisation, the plan of which alters the rights and obligations of parties.

As mentioned in Section A above, the SOA procedure, when used as a rescue device, is perceived to suffer from a number of deficiencies, notably the lack a moratorium provision and the difficulties associated with the organisation of class meetings, the meetings of which

³⁶ Tyler, *supra*, n 2 (Hong Kong Company Law Handbook), 758-760.

constitute the essential part of the decision-making mechanism in a procedure like s 166.³⁷ As will be seen in the discussion below, the Hong Kong courts have found ways to overcome these inadequacies under the existing company and insolvency law framework. For example, it is possible to achieve stays through the application of a number of insolvency procedures, such as adjournments of winding up petitions and provisional liquidation. The courts have also developed simple and clear rules on the organisation of class meetings with the result that a single class meeting suffices, except in circumstances where the rights of a class of claimants (typically employees in Hong Kong) are not adequately protected under the proposed rescue plan.³⁸

A characteristic of the SOA system that has not been sufficiently debated in the literature is the mode of reorganisation control that can be offered under this system. The US style debtor in possession (DIP) mode provided under Chapter 11 and the so-called “practitioner in possession” (PIP) mode under UK’s Administration regime³⁹ both have their pros and cons in terms of encouraging the debtor’s early entry into reorganisation, the provision of expert management for the debtor in reorganization, as well as control of strategic behaviours on the part of the pre-petition management in making reorganisation decisions.⁴⁰ The adoption of the correct mode of control is of fundamental importance, as the above-mentioned matters can determine the possibility of saving an ailing company or its business. As will be seen below, the SOA system offers a corporate control mechanism that operates in both the DIP and PIP mode in the right circumstances.

³⁷ See *supra* n 2.

³⁸ See *infra*, section G 1.

³⁹ V Finch, “Control and Coordination in Corporate Rescue” [2005] *Legal Studies* 347, 348.

⁴⁰ See generally D Hahn, “Concentrated Ownership and Control of the Corporate Reorganizations” (2004) 4 *Journal of Corporate Law Studies* 117, 133.

E. THE MODE OF REORGANISATION CONTROL UNDER THE SOA SYSTEM

The greatest advantage of the SOA system is probably that it offers a flexible reorganisation control mechanism that can function either in the DIP or PIP mode. The DIP model has two distinct advantages. First, it is conducive to the company's timely entry into the reorganisation process. Under the PIP model, which entails management displacement, the directors have an incentive to postpone the filing of reorganisation until delay is no longer possible, as commencement of reorganisation under this model means the end of their tenure.⁴¹ The delay in the commencement of the restructuring process may result in a loss of going concern value premium otherwise available for recovery. This is because when insolvency is in sight the debtor's management has the incentive to trade the company out of trouble by taking on overly risky projects, which may go wrong.⁴²

The DIP model encourages the debtor management to make timely filing of reorganisation as it leaves pre-petition management in control while the court's confirmation decision is pending.⁴³ An ailing company has a better chance to be resuscitated if rescue measures are taken early. The pre-petition management would have incentive to make timely filing of restructuring as successful reorganisation is consistent with the interests of company management. Even if it is no longer possible to rescue the debtor's business without changing ownership in the company and the purpose of the restructuring is to save the business rather than the company or maximise returns for creditors, an early entry into the reorganisation process is also desirable. A sale of a company's business or its assets while it is still operating

⁴¹ Hahn, *supra*, n 40, 139-140.

⁴² Hahn, *supra*, n 40, 139.

⁴³ Hahn, *supra* n 40, 141.

normally generates more of a return than a sale while the company is being liquidated, when the value of the company's assets falls dramatically.⁴⁴

Secondly, the DIP model allows the pre-petition management to be in charge of the debtor's business in the restructuring process. Where the purpose of the reorganisation is to rehabilitate the company or even a business sale while the company has not ceased to be a going concern, it is essential to continue the operation of the debtor's business in the interim. The company or its business cannot be saved according to the rescue plan if no viable business exists when the plan is confirmed. The extent to which the debtor's business can be prereserved depends on the competence of the management team during reorganisation.⁴⁵ Where the company's financial difficulty is not caused by the pre-petition management, the incumbent managers are more qualified, as compared to insolvency practitioners (IPs) appointed to replace the management under a PIP system, to manage business while the company is in the course of reorganisation. Incumbent directors are better placed to maintain relationships with trade and finance suppliers, dealing with company employees, and exploring and assessing business opportunities.⁴⁶

Moreover, pre-petition management is familiar with the business of the company, which helps ensure professional management of the debtor during reorganisation at no extra cost. In contrast, the IPs appointed to replace pre-petition management are new to the company and will need to acquire information and learn about the business of the debtor in order to manage the debtor's business properly. The learning cost of the IPs that the debtor must pay under a

⁴⁴ "[I]nsolvency procedures, once opened, can have a negative impact on goodwill and on the value of the business": R Parry, *Corporate Rescue* (London, Thomson Sweet & Maxwell, 2008), 16.

⁴⁵ Hahn, *supra* n 40, 145.

⁴⁶ Hahn, *supra* n 40, 145 – 146. For the advantages of a DIP regime, see also Booth and Lain, *supra*, n 5.

PIP regime may make rehabilitating the company more difficult as it further depletes the debtor's assets while it is in reorganisation.⁴⁷

A DIP regime, however, is not always optimal. First, incumbent management may not be able to make accurate pre-petition allocational decisions. Continued existence of the company is in the interest of the managers as it means the continuation of their tenure, at least where managers are themselves large shareholders. Pre-petition managers therefore have incentive to vote against insolvency even if the creditors will be better off if the company is wound-up. In other words, a pre-petition allocational decision made by incumbent directors may be distorted, which will result in social cost.⁴⁸

Secondly, it may not be appropriate in all circumstances to let the incumbent board manage the company in reorganisation. Leaving the debtor's management to incumbent directors is only appropriate if the company's distress is not caused by the managers' fault. If this is not the case, the effect of a DIP regime would be the same as "putting an alcoholic to be in charge of a pub".⁴⁹

Moreover, the DIP model may not be suitable for all types of companies. DIP suits reorganisation of large companies in dispersed ownership markets. As Hahn points out, where shareholdings are dispersed, the interests of the shareholders and directors are less aligned and the management enjoys a higher level of independence in corporations. The rift created by the separation of ownership and management widens when the company becomes insolvent, when the management's interests are more consistent with that of the creditors, who are now in control of the corporation.⁵⁰ The debtor management are therefore more

⁴⁷ Hahn *supra* n 40 146.

⁴⁸ Hahn *supra* n 40 138.

⁴⁹ G Moss, "Chapter 11: An English Lawyer's Critique" (1998) 11 *Insolvency Intelligence* 17, 18-19.

⁵⁰ M J Bienenstock, "Conflicts between management and the debtor-in-possession's fiduciary duties (1992) 61 *University of Cincinnati Law Review* 543, 545; Hahn, *supra* n 40, 131.

likely to be cooperative with the creditors in devising the reorganisation plan⁵¹ and less likely to engage in strategic behaviours in the interest of shareholders.

The DIP model, however, may not be suitable for small private companies or other types of companies where shareholders are concentrated in the hands of one or a group of strong shareholders. In these types of corporations, the management are often the “flesh and blood” of the controlling person or group.⁵² The lack of independence of the management of companies controlled by strong shareholders means that directors will act in the interests of shareholders, even when the company is insolvent. In other words, the management of closely controlled companies is more likely to act strategically in managing the debtor’s business in favour of the shareholders and to the detriment of the creditors. A strong director may, for example, direct the managers to engage in excessively risky projects. Upside gains from these risky investments favour the shareholders whereas the downside losses are shared by the creditors.⁵³ It follows that, in a concentrated ownership market, the PIP model is more suitable, as the protection of the creditors’ interest requires the removal of incumbent management.

The ownership market in Hong Kong is highly concentrated. As at 1995, according to the Second Report of the Corporate Working Group,⁵⁴ 53 per cent of all listed companies have one shareholder or one family group of shareholders owning 50 per cent or more of their entire issued share capital. More than 77 per cent of all listed companies have one shareholder or family group of shareholders owning 35 per cent or more of their entire issued

⁵¹ Hahn, *supra* n 40, 131

⁵² Hahn, *supra* n 40, 133.

⁵³ F H Buckley, “The American Stay” (1993-1994) 3 *Southern California Interdisciplinary Law Journal* 45; M Trebilcock and J Katz, “The Law and Economics of Corporate Insolvency: A North American Perspective” in Charles Rickett (ed), *Essays on Corporate Restructuring and Insolvency* (Wellington, Brooker’s, 1996) 1, 8; Hahn, *supra* n 40, 133.

⁵⁴ Hong Kong Society of Accountants, *Second Report of the Corporate Working Group* (HKSA, Hong Kong 1997) 4.

share capital. Eighty eight per cent of all listed companies have one shareholder or one family group of shareholders owning 25 per cent or more of their entire issued capital. The statistics quoted in Corporate Governance Review by Hong Kong's Standing Committee on Company Law Reform shows that as of April 2001, 24 per cent of the entire Hong Kong market capitalisation comprised of family-led companies and about 30 per cent comprised government-led listed companies.⁵⁵

The level of concentration of ownership in listed Hong Kong companies is perhaps even higher than what is demonstrated by the statistics above, given that in that region, “the quoted company often exists inside a network of family companies, *with only a minority of its voting, equity shares floated*” (emphasis added).⁵⁶ The strong position of controlling shareholders in Hong Kong listed companies is also evidenced in the fact that “[t]ypically the ‘controlling’ shareholders will appoint persons connected with them on to the boards [*sic*] of the company,”⁵⁷ and the managers and owners are often one and the same, whether the company is private or public.⁵⁸

Given the nature of the ownership market and the lack of separation of ownership and management in Hong Kong companies, the need for an undistorted allocational decision and to protect the interests of creditors while the debtor is in reorganisation requires the PIP control model. However, as discussed previously, when compared to the DIP model, a PIP regime is inferior in terms of the facilitation of timely entry into the reorganisation process and professional management of debtor business during reorganisation. An ideal control model should therefore leave the pre-petition management in charge but switch the control

⁵⁵ Corporate Governance Review by Hong Kong's Standing Committee on Company Law Reform, *Consultation Paper, Phase I*, accessed on 12 Aug 2011: www.info.gov.hk/cr/download/scclr/Rpt_e.pdf, 4-5.

⁵⁶ P Lawton and EL Tyler, *Division of Duties and Responsibilities between the Company Secretary and Directors in Hong Kong: Final Report* (Hong Kong, Hong Kong Institute of Company Secretaries, 2001) 16.

⁵⁷ S H Goo and A Carver, *Corporate Governance: the Hong Kong Debate* (Hong Kong, Thomson Sweet & Maxwell Asia, 2003) 35-36.

⁵⁸ P Lawton and EL Tyler, n 56, 14.

power to IPs where the danger of debtor opportunism warrants it or where the incumbent management fails to take timely rescue actions. The SOA system fits the description of this ideal model for at least three reasons. First, when the circumstances warrant it, it functions as a DIP system to facilitate the company's timely entry into the reorganisation process and to ensure of the quality of management of the debtor's business or assets in the interim. It is possible, prior to any enforcement actions by creditors, for the incumbent management to take timely restructuring steps, such as initiating compromise discussions with creditors, exploring the possibility of an injection of capital by potential investors (white knights),⁵⁹ and seeking court sanction of the restructuring plan.⁶⁰ The pre-petition management is able to initiate the restructuring process at their own instance, meaning that the system is capable of ensuring that the business of company is managed by those who are professionally most qualified to do so, before a sanction decision is made by the court.

The significance of the SOA system's role as a DIP regime is illustrated in the debtors' mode of control in the cases where restructuring proposals have been sanctioned by the courts (sanctioned cases). In terms of the extent to which the system operates in the DIP mode, in 28 out of the 53 cases decided since 1989, the proposed schemes were sanctioned by the courts.⁶¹ The reorganisation in 10 out of these 28 sanctioned cases was under the control of pre-petition management.⁶² In terms of The SOA system's ability to act as a DIP regime in appropriate circumstances, the quality of the system is evidenced by the fact that all, with the

⁵⁹ As in *Re Beauforte Investors Corp Ltd* [2008] HKEC 1003; *Re Kosonic Industries Ltd* [1999] HKEC 1183; *Re Sun Motor Industrial Co Ltd* [2008] HKEC 2006 and *Re Team Concepts Manufacturing Ltd* [2001] 3 HKLRD K7.

⁶⁰ *Re Yetyue Ltd* [2001] HKEC 1156.

⁶¹ See Appendix II.

⁶² *Re Kosonic Industries Ltd* [1999] HKEC 1183; *Re Team Concepts Manufacturing Ltd* [2001] 3 HKLRD K7; *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] 3 HKLRD 634; *Re Yetyue Ltd* [2001] HKEC 1156; *Re CIL Holdings Ltd* [2003] HKEC519; *Re APP (Hong Kong) Ltd* [2005] HKEC 1583; *Re Stereo Ltd* [2005] HKEC 1085; *Re Sun Motor Industrial Co Ltd* [2008] HKEC 2006; *Re Perfect Sense Group Ltd* [2007] HKEC 966; *Re Beauforte Investors Corp Ltd* [2008] HKEC 1003.

possible exception of one,⁶³ of the above-mentioned 10 cases demonstrate some characteristics that indicate an absence of of strategic behaviour on the part of the debtor management. These included (i) the company's distress was clearly caused by exogenous factors, such as the AFC,⁶⁴ the failure of the company's principal customer to make payments for goods supplied due to the customer's own financial difficulty,⁶⁵ the downfall of the parent entity caused by the wrongful conduct of the controller of that entity, which was the source of the company's business,⁶⁶ the sudden surge of the cost of production materials⁶⁷ or dissipation of the debtor's main assets held by a subsidiary based in another jurisdiction (due to the fault of a third party⁶⁸) without the knowledge of the company management;⁶⁹ (ii) that the restructuring was being funded by the company's controlling shareholders;⁷⁰ (iii) that most of the creditors were member companies within the same corporate group (intra group lenders); and (iv) that the company was under the control of a floating charge holder which promised to provide finance for the reorganisation pending the sanction of the scheme.⁷¹

If the company's financial stress is caused by external factors rather than the incompetence or disloyalty on the part of the pre-petition management, there is no reason to sacrifice the benefit of a timely commencement of the rescue process and securing expert management for

⁶³ This is *Re Stereo Ltd* [2005] HKEC 1085. The judgment of this case does not mention the cause of the company's distress. The time at which the company experienced financial difficulty (2003), however, indicates a likelihood that the debtor's stress is caused by the financial downturn caused by this deadly epidemic disease prevailed in Hong Kong in 2003.

⁶⁴ *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] 3 HKLRD 634 at para. 6.

⁶⁵ *Re Yetyue Ltd* [2001] HKEC 1156 at para. 3.

⁶⁶ *Re Perfect Sense Group Ltd* [2007] HKEC 966.

⁶⁷ *Re Sun Motor Industrial Co Ltd* [2008] HKEC 2006.

⁶⁸ In that case, the assets were held by the subsidiary (G Co) of one of the subsidiaries (O Co) of the company. O Co sold its shareholdings in G Co to an unrelated company T Co, which was to make the payment by way of a promissory note secured by the G Co shares. The promissory note was payable about eight months after the date of contract. T Co defaulted and the ownership of G Co shares reverted to O Co through the enforcement of the security. It appears that the assets held by G Co were dissipated before O Co resumed its control over G Co.

⁶⁹ *Re Beauforte Investors Corp Ltd* [2008] HKEC 1003.

⁷⁰ *Re Yetyue Ltd* [2001] HKEC 1156; *Re APP (Hong Kong) Ltd* [2005] HKEC 1583.

⁷¹ *Re Stereo Ltd* [2005] HKEC 1085.

a PIP regime. A PIP rescue model cannot be justified where the integrity and ability of the pre-petition board to manage the company's business is not questionable.

A willingness of the controlling shareholder to fund the debtor's restructuring suggests that it is prepared to use its own assets for the benefit of both the debtor and its creditors. This indicates an unlikelihood that the company controller will make self-interested decisions at the expense of the company or its creditors. Where some or even most of the company's creditors are intra-group lenders, the interest of the company or the whole group is aligned with that of its creditors. In other words, the company in this situation has a vested interest in making a value-maximising allocational decision in the best interest of its creditors.

Where the reorganisation plan put forward by the debtor board has the endorsement of a floating charge holder which promises continuing financial support pending the sanction of the proposed scheme, the accuracy of the allocational decision by the debtor management and the directors' ability to manage the company's business is largely guaranteed. The principal creditor will not lend support if the reorganisation proposal made by the debtor is inconsistent with the creditors' interests or it has doubts on the competence of the management, in which case the principal creditor may choose to crystallise the charge.

The second reason why the SOA system fits the "ideal control model" mentioned previously is that the system can operate in the PIP mode where it is appropriate to transfer the control power to IPs. Typically, the power of control will shift to IPs where creditors have taken enforcement actions such as lodging a winding up petition or a receiver is appointed by a debenture holder.⁷² The appointment of IPs is usually made when the debtor management has failed to take rescue steps at a sufficiently early stage. A failure to do so may be caused

⁷² Although it is possible for the debtor management to resist a winding up application by petitioning an adjournment of the proceeding: see Section F 1 below.

by tardiness or strategic delay on the part of the debtor management. In both cases a transfer of power is justifiable on the grounds of management opportunism, incompetence, or negligence. A PIP regime that the SOA system creates is thus unchallengeable on the ground of its inability to induce the debtor's timely entry into reorganisation. The focus of the inquiry should therefore be on the extent to which the lack of management expertise on the part of IPs is of concern when the system switches to the PIP mode.

More often than not, when an IP takes charge, the company would already be in a late stage of insolvency and it would be difficult for the IPs to resurrect it.⁷³ Consequently, in most circumstances, the task of an IP is to sell the company's going concern or assets.⁷⁴ Technically, a going concern or asset sale can be conducted by both the incumbent management or IPs. The problem is whether IPs are able to conduct such a sale expertly and manage the debtor's business or assets professionally in the course of the restructuring. The answer to this question is definitely in the affirmative. One important aspect of the job of IPs' is precisely the sale of the debtor's business or assets.⁷⁵ Going concern and asset sales are what they are trained to do. In most circumstances, by the time an IP is appointed, the debtor's business would not be engaging in any significant trading activities, due to the debtor's state of solvency. The issue of whether the IPs possess the expertise to manage the debtor's business effectively would hardly ever arise.

The third reason why the SOA system is able to operate in the "ideal" control mode is that the system, which does not assume a permanent character of either of the paradigmatic

⁷³ See, for example, Tang's comments on the utility of provisional liquidation for rehabilitating ailing companies: Tang, *supra*, n 10, 113.

⁷⁴ The extent to which the main task of IPs is going concern or asset sales in Hong Kong can be gleaned from a review of the 28 sanctioned cases mentioned above. In 16 out of these cases, the restructuring of the debtor was managed by IPs (see the asterisked items in Appendix II). With the exception of two cases (*Re Sharp Brave Co Ltd* [1999] HKEC 368 and *Re Merchants (Hong Kong) Ltd* [2005] HKEC 594), the restructurings in in of all of these 16 cases was organised to effect a sale of going concern or asset, or both.

⁷⁵ See Cork Committee's comments on receivers' ability to dispose the whole or part of the debtor's business as a going concern: *Insolvency Law and Practice: Report of the Review Committee*, Cmnd 8558 (the Cork Report), 1982, 117.

reorganisation control models, is effective in ensuring the accuracy of the initial allocational decision made by the incumbent management. As the SOA system does not operate in the PIP mode in the absence of any creditors' enforcement actions, the debtor management will not lose their tenure for entering the company into the reorganisation process. The debtor controller is therefore unlikely to delay the restructuring process for the sake of entrenching their position. In fact, a delay can backfire on the prepetition management. A delay may result in the displacement of the company management when creditors take enforcement actions.

On the other hand, given that the SOA system is not a formal DIP regime either, entering into debtor-controlled reorganization after the creditor's enforcement action is taken is impossible unless with the stay granted by the court through adjourning the winding up petition. It follows that the incumbent management has little chance to enter into reorganisation for the purpose of extending their tenure when liquidation is the optimal course of action for the creditors.

F. ACHIEVING A STAY

Corporate reorganisation entails an adjustment of the rights and obligations of different stakeholders, which takes time.⁷⁶ On the other hand, company creditors tend to exercise their individual remedies against the company when the company is unable to meet the debts owed to all of its creditors.⁷⁷ A race to collect,⁷⁸ when the company is in a rescue situation, will injure the interests of creditors as a whole. It does so through, among other things,

⁷⁶ DG. Baird, *The Elements of Bankruptcy* (NY, Foundation Press, , 3rd edn, 2010) 169; LM LoPucki & GG Triantis, *supra* n 2, 110, 117.

⁷⁷ TH Jackson, *The Logic and Limits of Bankruptcy Law* (Washington DC, BeardBooks, 1986) 10-11.

dismembering the company and thereby denying the management and claimholders, as a collectivity, the opportunity to deliberate on the deployment of the debtor's assets, which may result in a distorted decision on this matter. It is therefore crucial, for a successful reorganisation of the debtor, to suspend the creditors' rights through a stay mechanism.

Section 166, CO does not provide for an automatic stay. It is, however, possible to achieve a stay under the SOA system through at least three avenues, namely, adjournments of winding up petitions, provisional liquidation, and liquidation. The relevance and the ways in which a stay is achieved through these avenues are considered below.

1. Adjournment of Winding-up Petitions

On many occasions where the court is asked to sanction an SOA for a reorganization purpose, a winding-up petition would have already been made against the company. An order to adjourn a winding-up petition gives the company a respite during which the viability of a restructuring scheme can be considered and, where appropriate, a rescue plan prepared. A complex restructuring project is likely to require more than one adjournment. To ensure that an adjournment is granted only where a respite is genuinely needed to devise a rescue plan, the court must be guided on the circumstances in which, the conditions under which, and the duration for which, the initial and subsequent adjournments can be granted for reorganization purposes. Through their judicial practice since 1989, the Hong Kong courts have developed a complete set of principles on the sanction of adjournment applications for rescue purposes.

(a) Initial adjournment

The purpose of an initial adjournment is to enable the debtor company to consider the viability of a restructuring. In *Re X10 Ltd*,⁷⁹ Jones J expressed the view that a period in the vicinity of four weeks would be sufficient to enable the company to make this assessment.⁸⁰ His Lordship recognised that there might be circumstances justifying longer adjournments or more than one adjournments.⁸¹ This four-week rule was endorsed in the subsequent Court of Appeal case *Re Esquire (Electronics) Ltd (Re Esquire)*.⁸²

(b) Further adjournments

Once the court is convinced that a restructuring is viable, it will be willing to grant further adjournments to allow time for the debtor to complete the necessary steps to obtain a court sanction of the scheme.⁸³ To grant a further adjournment, the court needs to be convinced that two criteria are satisfied. First, the proposed restructuring scheme must have the ‘in principle’ support of the majority of creditors (the ‘in-principle’ support criterion). Secondly, it must be reasonably arguable that the court would sanction the proposed scheme (the viability criterion).⁸⁴

The ‘in-principle support’ criterion entails an examination of the extent of creditors’ support for the proposed scheme. That notwithstanding, no specific rules appear to have been formulated on the type of majority that must be proven to establish the creditors’ ‘in-principle’ support. What is clear is that in virtually all of the cases where subsequent adjournments were granted, the companies in question were able to prove that the proposed

⁷⁹ *Re X10 Ltd* [1989] HKLR 306 HC.

⁸⁰ *Re X10 Ltd* [1989] HKLR 306 HC per Jones J at [3].

⁸¹ *Re X10 Ltd* [1989] HKLR 306 at [3].

⁸² [1996] HKLY 203 CA.

⁸³ *Re UDL Holdings Ltd* [1999] 2 HKLRD 817 per Le Pichon J at 822-823.

⁸⁴ *Re APP (Hong Kong) Ltd* [2004] HKEC 522 per Kwan J at [23], [26].

scheme had ‘in principle’ support of three-quarters (or thereabout) in value of the creditors.⁸⁵

This suggests that the supermajority required for the sanction of a s 166 proposal (“a majority in number representing three- quarters in value of the creditors”) has been used as a guide to determine whether there is ‘in principle support’ when considering an adjournment petition. According to Le Pichon J, an adjournment is only justified if a restructuring proposal is shown to have the necessary ‘in principle’ support *within the few weeks* of the first hearing.⁸⁶

The content of the viability criterion may differ slightly depending on the nature and purpose of the proposed restructuring scheme. Where the proposed scheme entails a sale of assets to an independent investor, the viability of the scheme is assessed by comparing the position of the (normally unsecured) creditors in a restructuring scenario with that in a liquidation situation. A proposed scheme is generally regarded as viable if the proposed scheme will result in a better return for scheme creditors when compared with their position in the liquidation senario.⁸⁷

Where the proposed scheme aims at rehabilitating the company, at least where the estimated liquidation recoveries for unsecured creditors would be practially zero, the in principle support of the proposed scheme by a large number of creditors may *ipso facto* be a sufficient reason for granting an adjournment. This is especially so where the creditors in support of a rescue scheme are mostly financial creditors which have made their commercial decisions on the strength of a liquidation analysis prepared by a liquidation/corporate recovery specialist.⁸⁸

⁸⁵ *Re UDL Holdings Ltd* [1999] 2 HKLRD 817; *Re CIL Holdings Ltd* [2002] HKEC 97; *Re APP (Hong Kong) Ltd* [2004] HKEC 522; *Re Advanced Wireless Group Ltd* [2007] HKEC 764.

⁸⁶ *Re Hong Kong Brewing & Restaurants Ltd* [1999] HKEC 637 (pinpoint reference unavailable).

⁸⁷ *Re Advanced Wireless Group Ltd* [2007] HKEC764 (liquidation scenario: in the range of 1.68 % and 3.01%, restructuring scenario: in the range of 9.99% and 16.52%); *Re APP (Hong Kong) Ltd* [2004] HKEC 522 (liquidation scenario: in the range of 2.6% to 4%; restructuring scenario: immediate 10% return or one new share of par value HK 1 for every HK 1 of their admitted claims, such shares ranking *pari passu* to the existing shares).

⁸⁸ *Re UDL Holdings Ltd* [1999] 2 HKLRD 817 at 828 per Le Pichon J.

The duration of each of the subsequent adjournments varies between one week to three months.⁸⁹ A complex restructuring process may require a stay for a period of close to two years.⁹⁰ The courts in Hong Kong have shown a willingness to grant multiple adjournments to accommodate this need.⁹¹ Subsequent adjournments have been granted to enable the company to (i) conduct negotiations with potential investors, (ii) have a liquidation analysis prepared by a corporate recovery/liquidation specialist, (iii) put a restructuring proposal to its creditors to ascertain the creditors' views, (iv) prepare scheme documents and (v) make an application to convene a creditors' meeting to vote on the scheme.⁹²

2. Provisional Liquidation

The appointment of a provisional liquidator triggers an automatic stay of proceedings against the company.⁹³ Section 193 of the CO gives the courts the power to appoint a liquidator provisionally after the presentation of a winding-up petition and before the making of a winding-up order.⁹⁴ Such an appointment, according to s 192, must be “for the purpose of conducting the proceedings in winding up a company and performing such duties in reference thereto as the court may impose”.⁹⁵

⁸⁹ *In Re Advanced Wireless Group Ltd* [2007] HKEC 764, the company was granted a number of adjournments between October 2006 and July 2007. The shortest adjournment granted was a week (see [4] in the judgment). The longest, three months (see [53]).

⁹⁰ For example, in *Re CIL Holdings Ltd* [2003] HKEC 519, the winding up petition was presented on 11 May 2001 and the proposed scheme was sanctioned on 2 April 2003. The total period of stay granted through extending adjournments amounted to close to 23 months.

⁹¹ See *Re UDL Argos Engineering & Heavy Industries Co Ltd* [1999] HKEC 1054; *Re UDL Holdings Ltd* [1999] 2 HKLRD 817; *Re CIL Holdings Ltd* [2002] HKEC 97; *APP (Hong Kong) Ltd* [2004] HKEC 522, and *Re Advanced Wireless Group Ltd* [2007] HKEC764. *Re*

⁹² For example, *Re UDL Holdings Ltd* [1999] 2 HKLRD 817; *Re UDL Argos Engineering & Heavy Industries Co Ltd* [1999] HKEC 1054; *Re CIL Holdings Ltd* [2002] HKEC 97; *Re APP (Hong Kong) Ltd* [2004] HKEC 522, and *Re Advanced Wireless Group Ltd* [2007] HKEC764.

⁹³ Companies Ordinance, s 186.

⁹⁴ Companies Ordinance, s 193.

⁹⁵ Companies Ordinance, s 192.

The traditional common law position on the appointment of a provisional liquidator was that such an appointment could be made to protect the company's assets pending the outcome of the winding-up petition, to maintain the status quo, and to prevent any creditor from getting priority.⁹⁶ The modern position, however, appears to be that the appointment of a provisional liquidator does not have to be restricted to the above-mentioned purposes. Megarry VC observed in *Re Highfield Commodities Ltd*⁹⁷ that there was no hint in the UK equivalent of s 193, CO that an appointment of a provisional liquidator must be restricted to certain types of cases.⁹⁸ In this case, Megarry VC refused to remove the provisional liquidator appointed by the Secretary of State to protect members of the public from the alleged frauds of the company.

The less restrictive position set out by Megarry VC appears to have ushered in an era, which ended in 2003, during which provisional liquidation was used to achieve moratoria for financially distressed insurance companies in the UK. Prior to the enactment of Enterprise Act 2002 (UK), provisions for Administration contained in Part II of the Insolvency Act 1986 (UK) did not apply to insurance companies. During that period, the courts developed the practice of using a winding-up petition as the basis for the appointment of provisional liquidators to resolve financial difficulties by an SOA under s 425 of the Companies Act

⁹⁶ *Palmer's Company Law* (London, Stevens & Sons, 24th edn, 1987), 1394; G Lightman & G Moss, *The Law of Receivers of Companies* (London, Sweet & Maxwell, 2nd Rev Ed edn, 1994), 19-20; LSealy & Milman, *Annotated Guide to the Insolvency Legislation* (London, Sweet & Maxwell, 9th edn, 2006), 166; Paul Kwan, *Hong Kong Corporate Law* (LexisNexis, Hong Kong 2006) 1283; M Philips & G Moss, *Provisional Liquidators: New Uses for an Old Remedy*, 6 *Insolv Int* 1 (1993); *Re Dry Docks Corporations of London* (1888) 39 Ch D 306 per Kay J at first instance; *Re Hammersmith Town Hall Company* (1877) 6 Ch D 112; *Re Carpark Industrial Pty Ltd* [1967] 1 NSW 337, 341.

⁹⁷ [1985] 1 WLR 149.

⁹⁸ *Re Highfield Commodities Ltd* [1985] 1 WLR 149 at 159 C-F.

(UK) 1985.⁹⁹ This practice has been dealt with and has been approved by judges of different courts.¹⁰⁰

The creative use of provisional liquidation to obtain moratoria in England has inspired courts in Hong Kong to do the same, albeit in a wider context. There is no space to outline in this article the development of the jurisprudence by Hong Kong courts on provisional liquidation as a stay device. It is, however, necessary to mention the recent twist on the evolvement of the law on provisional liquidation in Hong Kong. This twist is caused by an *obiter dictum* in Kwan J's judgment in *Re Legend International Resorts Ltd (Re Legend)*,¹⁰¹ the case of which represents the high water mark in Hong Kong on the creative use of provisional liquidation in the context of reorganisation. Kwan J's stated in that case that it was within the jurisdiction of the courts to appoint provisional liquidators to explore, formulate and pursue a corporate rescue.¹⁰²

This statement (which Rogers V-P described as 'bold' in His Lordship's appeal judgment) caused an apparent backlash on the use of provisional liquidation as a reorganisation device in Hong Kong. In His Lordship's judgement, Rogers V-P stressed the difference between the appointment of a provisional liquidator on the basis that the company was insolvent and that its assets were in jeopardy and an appointment solely for the purpose of enabling a corporate rescue to take place.¹⁰³ His Lordship held that the power to appoint provisional liquidators was provided for under s 192 of the CO, which stated that the appointment of a provisional

⁹⁹ *Re English & American Insurance Co Ltd* [1994] 1 BCLC 649 per Harman J at 650; *Smith v UIC Insurance Co Ltd* [2001] BCC 11 per Judge Dean QC at 20-21.

¹⁰⁰ *Re English & American Insurance Co Ltd* [1994] 1 BCLC 649 per Harman J at 650; *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241 per Chadwick LJ at para 8; *Smith v UIC Insurance Co Ltd* [2001] BCC 11 per Judge Dean QC at 20-21.

¹⁰¹ [2005] 3 HKLRD 16 CFI.

¹⁰² *Re Legend International Resorts Ltd* [2005] 3 HKLRD 16 at 49.

¹⁰³ *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192 at 203.

liquidator must be for the purpose of winding-up, rather than avoiding winding-up, of a company.¹⁰⁴

His Lordship's comment in *Re Legend* appears to have sent out a negative message about the use of provisional liquidation as a rescue device.¹⁰⁵ For example, the 2009 Consultation Paper on corporate rescue procedure prepared by Hong Kong's Financial Services and the Treasury Bureau justifies the need for enacting a formal rescue procedure on the basis that, *inter alia*, Rogers V-P's judgment in *Re Legend* has put in place some limitations on the use of provisional liquidation procedures for rescue purposes.¹⁰⁶

In fact, the impact of the Court of Appeal's decision in *Re Legend* on the use of provisional liquidation as a restructuring tool may have been overstated. Rogers V-P's view on Kwan J's 'bold' statement was made as *obiter dicta* only. The difference that His Lordship noted between (i) the appointment of a provisional liquidator on the basis that the company is insolvent and that its assets are in jeopardy and (ii) an appointment solely for the purpose of enabling a corporate rescue to take place is, in any case, insignificant. As His Lordship himself noted: "[t]he difference, may, in most cases, be merely a matter of emphasis".¹⁰⁷ Generally speaking, there is no need for devising a corporate rescue scheme when the company is solvent.

Provisional liquidation has rarely ever been used to facilitate a corporate rescue in the sense of rehabilitating the company.¹⁰⁸ The main reason appears to be that the appointment of

¹⁰⁴ *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192 CA at 203-204.

¹⁰⁵ See Booth, et al, *supra* n 2, 308-309; Douglas W Arner et al, "Property Rights, Collateral, Creditor Rights, and Insolvency in East Asia" (2007) 42 *Texas International Law Journal* 515, 554; Anil Hargoven, *Shareholders as Creditors in Hong Kong Corporate Insolvency: Myth or Reality?* (2008) 38 *Hong Kong Law Journal* 685, 703.

¹⁰⁶ Financial Services and the Treasury Bureau, Hong Kong SAR, *Review of Corporate Rescue Procedure Legislative Proposals: Consultation Paper 7* (Hong Kong, October 2009).

¹⁰⁷ *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192 CA at 203.

¹⁰⁸ In six out of the 53 cases referred to in Section A the scheme was proposed for the purpose of rehabilitating the companies: *Re Sharp Brave Co Ltd* [1999] HKEC 368; *Re Team Concepts Manufacturing Ltd* [2001] 3 HKLRD K7; *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] 3 HKLRD 634; *Re Yetyue*

provisional liquidators in Hong Kong often takes place at a very late stage in the demise of the company.¹⁰⁹ Where the proposed restructuring scheme involves a sale of assets to an independent third party, a need for preserving the assets to be sold is self-evident. It would not be difficult to meet the protection of assets requirement in most cases. *Re Plus Holdings Ltd*¹¹⁰ is an indicative post-*Re Legend* example case. There, Kwan J held that the appointment of provisional liquidators was essential for the preservation of the company's listing status, which could be sold to a third party investor, should the proposed restructuring succeed. In this case, the provisional liquidators have successfully devised a restructuring by an SOA, which was sanctioned by the court.¹¹¹

3. Winding-up

A winding-up order made by the court stays all existing and future actions and proceedings.¹¹² The relevance of an automatic stay triggered by a winding-up order is that this order, while signalling the commencement of liquidation process, does not necessarily preclude the possibility of reorganisation. In fact, in Hong Kong, a restructuring plan is sometimes devised or carried out after a winding up order has been made against the company.¹¹³ It is quite common in Hong Kong for potential investors to approach the

Ltd [2001] HKEC 1156; *Re APP (Hong Kong) Ltd* [2004] HKEC 522; *Re Merchants (Hong Kong) Ltd* [2005] HKEC 594. The scheme in none of these cases was devised or managed by provisional liquidators.

¹⁰⁹ Tang (n 10) 113.

¹¹⁰ [2007] 2 HKLRD 725.

¹¹¹ *Re Plus Holdings Ltd* [2008] HKEC 1327.

¹¹² Companies Ordinance, s 186.

¹¹³ For case examples where the restructuring plans initiated/organized by liquidators of the companies in liquidation, see: *Kansa General International Insurance Co Ltd* [1999] 2 HKLRD 429; *Re Yaohan Hong Kong Corp Ltd* [2001] 1 HKLRD 363; *Re Akai Holdings Ltd* [2002] HKEC 1365; *Re Akai Holdings Ltd* [2002] HKEC 1365; *Re Albatronics (Far East) Co Ltd* [2002] HKLRD (Yrbk) 180; ; *Re Wah Nam Group Ltd* [2002]

liquidators with restructuring proposals after a winding-up order has been made.¹¹⁴ Alternatively, a liquidator may take the initiative to find potential investors and put forward a rescue proposal.¹¹⁵ A liquidator, for example, may prepare and distribute an information package to investors and invite proposals for restructuring to realise core assets of the company or group.¹¹⁶ Also, even when a winding up order is made, it is possible for the holding company of the failed entity, which is willing to fund a rescue scheme, to initiate a compromise negotiation with the creditors.¹¹⁷ The secured creditors' right to enforcement action has not appeared to have affected the effect of winding up as a stay device to any significant extent. It is sometimes the case that by the time the winding up order is made, the only realisable asset of the company is its listing status.¹¹⁸ Where the purpose of the restructuring is to sell the company as a going concern, it is possible for the company to reach an agreement with the secured creditors so that the latter are paid "the agreed value of their security interest".¹¹⁹ In certain circumstances, the investor may be willing to purchase the

HKEC 1090; *Re Moulin Global Eyecare Holdings Ltd* [2007] 4 HKLRD 363; *Re Dickson Group Holdings Ltd* [2008] HKEC 899; *Re ; Re Zhu Kuan (Hong Kong) Co Ltd* [2007] HKEC 1947.

¹¹⁴ For example, *Re Kansa General International Insurance Ltd* [1999] 2 HKLRD 429; *Re Sharp Brave Co Ltd* [1999] HKEC 368; *Re Akai Holdings Ltd* [2002] HKEC 1365.

¹¹⁵ For example, *Re Dickson Group Holdings Ltd* [2008] HKEC 899.

¹¹⁶ For example, *Re Wah Nam Group Ltd* (No 2) [2003] 1 HKLRD 282.

¹¹⁷ See *Re Sharp Brave Co Ltd* [1999] HKEC 368.

¹¹⁸ *Re Akai Holdings Ltd* [2002] HKEC 1365; *Re Albatronics (Far East) Co Ltd* [2002] HKLRD (Yrbk) 180. Listing status is not a form of corporate assets for accounting purposes in the sense that it is not listed in the company's balance sheet. They are, however, legally recognised as the company's assets (In *Re Plus Holdings Ltd* [2007] 2 HKLRD 725, for example, Kwan J approved an application for the appointment of a provisional liquidator on the basis of the need for protecting the company's "assets" – its listing status). Investors in Hong Kong are willing to purchase a failed listed company's listing status. In Hong Kong, "it has historically been technically easier, if not always cheaper, to take over and revive an existing company by restructuring it and injecting new assets than to go for the alternative, a new floatation by way of a new issue or offer for sale" (Stewart Smith, *Some Problems in Reorganising Insolvent Companies* in M Merry (ed), *LAW LECTURES FOR PRACTITIONERS* (1983) 227, 241 accessed on 11 October 2011 at <http://sunzi.lib.hku.hk/hkjo/article.jsp?book=14&issue=140006>). A further reason why investors are willing to 'purchase' a company's listing status lies in the considerable goodwill attached, and the spread of shareholders that, at least in certain cases, goes with it (ibid).

¹¹⁹ *Re Dickson Group Holdings Ltd* [2008] HKEC 899 at [17].

company's business (including its listing status) even if the secured creditors have realised their security interests.¹²⁰

Evaluation

Apart from the provision of a moratorium, the stay devices under the SOA system perform a number of other functions of the rescue system. First, the DIP and PIP modes of the rescue system are facilitated by a stay effected through the adjournments granted by the courts or a moratorium triggered by, among other things, the appointment of external administrators (such as a liquidator or a provisional liquidator). In other words, the stay devices provide for the flexibility of reorganisation control mechanisms discussed in section E.

Secondly, the stay devices function as a screening tool to sift out ineligible firms from the reorganisation process. This function is necessary when the SOA system operates in the DIP mode. As previously mentioned,¹²¹ where the debtor is under the control of the pre-petition management, creditors' interests can be harmed by debtor overreaching activities. Keeping firms that do not have a prospect of a successful reorganisation out of the restructuring process is an important way of protecting creditors from debtor opportunism.

The chief methods of screening out ineligible firms under Hong Kong's SOA-based reorganisation system are the mandatory disclosure and the mandatory court appearance requirements.¹²² Under this system, it is impossible to achieve a moratorium through adjournments of winding up petitions or to obtain court sanction of a proposed plan unless the debtor meets the disclosure requirements. To obtain an adjournment, the petitioner will need to prove, among other things, that there are reasonable prospects of the scheme

¹²⁰ See *Re Dickson Group Holdings Ltd* [2008] HKEC 899 at [17].

¹²¹ See *supra* text to n 53.

¹²² These two methods are also used in America and Canada to monitor the debtor in possession: LoPucki & Triantis, *supra* n 2, 150-151.

obtaining the approval of both the majority scheme participants and the court.¹²³ To demonstrate the prospects of obtaining this approval, the applicant will need to provide the court with information on, among other things, the financial position of the company. A failure to place before the court the company's financial statements such as the balance sheet or cash flow statement will result in a rejection of the adjournment petition.¹²⁴

A proposed s 166 plan will only be sanctioned if (1) "the provisions of the statute have been complied with",¹²⁵ (2) "the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent",¹²⁶ and (3) "the scheme is such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve".¹²⁷ To satisfy these conditions, the petitioner is required to attach an explanatory statement to the notice to be sent to the participants in the proposed scheme.¹²⁸ That statement must explain, among other things, the effect of the proposed scheme and disclose any material interests of the directors of the company and the effect of their personal interests on the proposal.¹²⁹ To demonstrate the effect of the proposed scheme, an explanatory statement typically contains, among other things, information about the company's assets, as well as a comparison between the creditors' position in liquidation and that under the proposed scheme.¹³⁰

¹²³ *Re UDL Holdings Ltd* [1999] 2 HKILRD 817; *Credit Lyonnais v SK Global Hong Kong Ltd* [2003] 4 HKC 104 at 113 per Rogers V-P; *The Cheery City Contractors Ltd* [2004] HKEC 504 at para 28 per Kwan J.

¹²⁴ *Re Golden Dragon Land Development Ltd* [1999] 3 HKILRD J4; *Re Koldtech Development (International) Ltd* [2005] HKEC 1190; *Re Luen Fai Piecegoods & Cloths Co Ltd* [2010] HKEC 323.

¹²⁵ *Buckley on the Companies Act* (Londong, Butterworths, 14th edn, 1981) 473-474.

¹²⁶ *Buckley on the Companies Act* (n 125) 473-474.

¹²⁷ *Buckley on the Companies Act* (n 125) 473-474.

¹²⁸ Companies Ordinance, s 166A.

¹²⁹ Companies Ordinance, s 166A (1) (a).

¹³⁰ Where the proposer of a scheme fails to disclose the required information in the statement, the proposed scheme cannot proceed: *Re Cherry City Contractors Ltd* [2004] HKEC 504; *Re Koldtech Development (International) Ltd* [2005] HKEC 1190.

The enforcement of disclosure requirements is carried out through mandatory court appearances by the petitioner who applies for an adjournment or sanction of the scheme. As mentioned previously, the initial adjournment is, generally speaking, only granted for up to four weeks and the duration of each subsequent adjournment varies between one week and three months.¹³¹ This means that an applicant would typically have to make a number of appearances before the proposed scheme can be sanctioned. To obtain a subsequent adjournment, the applicant must prove the continuing satisfaction of the ‘in-principle support’ criterion and the ‘viability’ criterion through meeting the relevant disclosure requirements.¹³² Companies that fail to do so¹³³ are, in normal circumstances, eliminated from the reorganisation process.¹³⁴

Finally, the stay mechanism under the SOA system helps reduce the cost of settlement of *ex post* disputes. A distinct feature of the stay regime under the SOA system is that it is court-controlled. The decisions on the grants of an adjournment, appointment of provisional liquidators, and the making of winding up orders are all made by the courts. In other words, the courts start their control over the reorganisation process at the beginning stage. Screening

¹³¹ See *supra* text to n 89.

¹³² See *supra*, text to n 83.

¹³³ For example, where the company fails to (1) adduce evidence that it has forwarded a rescue proposal, which has the in-principle support of the scheme participants (ii) provide the court with its financial statements: *Re Beauty China Holdings Ltd* [2009] HKEC 1499; *Re China Motor Vehicle Economic Development Co Ltd* [2000] HKEC 61; *In the Matter of Gold-Face Holding Ltd* [2006] HKEC 1795; *Re Greater Beijing First Expressways Ltd* [2000] HKEC 651; *Re Hong Kong Brewing & Restaurants Ltd* [1999] HKEC 637; *Re Koldtech Development (International) Ltd* [2005] HKEC 1190; *Re Luen Fai Picergoods & Cloths Co Ltd* [2010] HKEC 323; *Re Tse Yu Hong Ltd* [1999] HKEC 1048. A debtor company also fails to meet the disclosure requirements if the disclosure documents contain misleading information on the rights of scheme participants in a liquidation and a restructuring scenario: *Re Cheery City Contractors Ltd* [2004] HKEC 504.

¹³⁴ The rigor at which the reorganization cases are screened at the pre-confirmation phase means that when a case reaches the sanctioning stage, most of the ineligible firms would have been sifted out of the reorganization process. That notwithstanding, court appearances at the confirmation stage still plays a valuable gate-keeping role. An example is *Re S Megga Telecommunications Ltd* [2002] HKEC 1344, where the court refused to sanction the proposed scheme on the ground that a certain class of creditors was classified with the general unsecured creditors where they should have been allowed to vote as a separate class. Admittedly, however, *Re S Megga* is on the fair treatment of different classes of creditors, rather than protecting the scheme participants from the overreaching conduct of company controllers.

out of ineligible firms at an early stage helps reduce the possibility of *ex post* disputes, which can be very costly to settle.

Ex post disputes are more likely to arise when the commencement of a formal reorganisation process is not under the courts' control. A number of Australian decisions on Voluntary Administration (VA) and the associated procedure of Deed of Company Arrangement (DCA) illustrate the point. Under a VA and DCA, a stay can be obtained and a compromise reached through creditors' meetings without court orders.¹³⁵ Court experience in Australia shows that due to the lack of court control, invoking these procedures "often leads to confusion and doubt, which will need ultimately to be resolved by resort to the courts".¹³⁶ The confusion and doubt that requires court clarification are often about whether procedural or even substantive requirements for obtaining a compromise with creditors have been met.¹³⁷ The need to settle *ex post* disputes can make a VA style rescue procedure costly. First, an absence of court control until the emergence of disputes has the effect of postponing the courts' scrutiny on the debtor's eligibility for reorganisation, the postponement of which may, ironically, lead to distorted allocational decisions. For example, the failure to meet a mandatory procedural requirement may lead to an irreversible allocational decision against the wishes of the creditors as a whole.¹³⁸

Secondly, *ex post* disputes are often resolved through a protracted court process. The complexity of the issues faced by the courts and the possibility of appeals against court

¹³⁵ Corporations Act 2001, Part 5.3A, Division 6, 7 (moratorium); ss 436E, 439A (creditors' meetings).

¹³⁶ *MYT Engineering Pty Ltd v Mulcon Pty Ltd* (1997) 140 FLR 247 at 251 per Powell JA.

¹³⁷ For example, *McVeigh & McDonald v Linen House Pty Ltd & Rugs Galore Australia Ltd* (2000) 18 ACLC 311 (failure of the Administrator to inform creditors of material information); *MYT Engineering Pty Ltd v Mulcon Pty Ltd* (1997) 140 FLR 247 (failure on the part of the debtor management to execute the Company Deed of Arrangement within the statutorily imposed time limit); *Australasian Memory Pty Ltd v Brien* (1998) 29 ACSR 344 (convening a creditors' meeting on a date earlier than the earliest date permitted under the Corporations Act 2001).

¹³⁸ For example, Corporations Act 2001, s 446A provides that a company is taken to have passed into liquidation where the provision (s 444B(2)) on the time of executing the Company Deed of Arrangement is not complied with. The company in *Myt Engineering Pty Ltd v Mulcon Pty Ltd* (1997) 25 ACSR 78 entered into liquidation against the creditors' collective decision to reorganize the company precisely for this reason.

decisions often result in situations where the ultimate fate of an attempted VA in Australia may not be known “until the better part of five years after the event”.¹³⁹ Lengthy delays in the completion of a VA will result in correspondingly extended postponement in the deployment of the debtor’s assets and a significantly increase the legal and other professional costs.

It may be possible to argue that the difference that the SOA system makes, as compared with VA, is that it just shifts the cost of resolving conflicts to an earlier point of time and *ex ante* resolution of issues that are likely to give rise to conflicts may result in a reduction of number of cases that may be allowed into the reorganisation process. The answer to this view is that the available data on the use and effect of VA suggests that in terms of the number of successful schemes/administrations, the SOA system is unlikely to be inferior to VA. According to a research paper commissioned by the Australian Securities Commission, of the 55 VAs surveyed, only 18 or 33% of the companies entered the VA process for restructuring purposes and at least 75% of the companies that have entered into VA would end up being deregistered.¹⁴⁰ In contrast, of the 53 SOA cases surveyed for the purpose of this article, the proposed SOA plan was approved in 28 cases, representing about 53% of the total cases surveyed.¹⁴¹ Due to the gatekeeping function of the stay mechanism of the SOA system, most, if not all, of the companies in these 28 cases would have entered into the reorganisation process for reorganisation purposes. The number of successful reorganisations conducted through SOA schemes therefore is unlikely to be smaller than that via VAs.

¹³⁹ *Australasian Memory Pty Ltd v Brien* (1998) 29 ACSR 344 per Powell JA at 347 (commenting on the possible outcome of the appeal to the High Court by the appellant company in *MYT Engineering Pty Ltd v Mulcon Pty Ltd* (1997) 25 ACSR 78).

¹⁴⁰ See Parliamentary Joint Committee on Corporate and Financial Services, Corporate Insolvency Laws: a Stocktake (June 2004, Canberra) 74.

¹⁴¹ See *supra*, text to n 62.

G. ACHIEVING AN ACCURATE ALLOCATIONAL DECISION THROUGH AN EFFECTIVE DECISION-MAKING PROCEDURE

When a company has entered into a restructuring procedure, the remaining assets, in a practical sense, belong to the company's creditors.¹⁴² It is therefore up to the creditors to determine on how the debtor's assets should be deployed. As mentioned in section A, it is possible for claimholders to make such a decision through a workout. A decision made through a workout must be made on the basis of unanimous consent,¹⁴³ which can be hard to achieve. A recalcitrant claimant, for example, may decide to veto a plan in order to hold out for a different plan which is more favourable to itself.¹⁴⁴ To resolve this problem, it is necessary to provide for a collective decision-making mechanism that binds potential dissenters.

A collective decision-making process designed to bind dissenters operates on the basis of majority rule. A poorly designed decision-making mechanism can however be used by opportunistic claimants to their own advantage at the cost of the collective interest of all the claimholders. For example, creditors whose interests are consistent with the continuing existence of the debtor (those who have a "collateral relationship" with the company) may impose an inefficient reorganisation on senior creditors or those who do not have any collateral stakes in the survival of the company. Junior creditors and creditors with small claims may have an incentive to approve a risky reorganisation. These creditors are not likely

¹⁴² Although in a legal sense, the company itself will remain the owner of the assets even when it is in a compulsory winding up (*Ayerst (Inspector of Taxes) v C & K (Construction) Ltd* [1976] AC 167; *Franklin's Selfserve Pty Ltd v Commissioner of Taxation* (1970) 125 CLR 52; *Commissioner of Taxation v Linter Textiles Australia Ltd (In Liq)* (2005) 220 CLR 592), the shares in such a company have no intrinsic value and any disposal of the company's assets would necessarily be for the benefit of the creditors (*Re Yaohan Hong Kong Corp Ltd* [2001] 1 HKLRD 363 CA).

¹⁴³ JJ Quinn, "Corporate Reorganization and Strategic Behaviour: an Economic Analysis of Canadian Insolvency Law and Recent Proposals for Reform" (1985) 23 *Osgoode Hall Law Journal* 1, 3; Tyler, *supra*, n 15, 758.

¹⁴⁴ GG Triantis, "Mitigating the Collective Action Problem of Debt Enforcement through Bankruptcy Law: Bill C-22 and its Shadow" (1992) 20 *Canadian Business Law Journal* 242, 246.

to recover very much, if anything, from liquidation and are therefore unlikely to have an incentive to support efficient liquidation. On the other hand, they will not suffer any significant loss if the proposed reorganisation fails, as the risk of a reorganisation will mostly be borne by creditors with large claims.¹⁴⁵

On the other hand, creditors of different seniority under a distribution scheme or those who do not have a collateral stake¹⁴⁶ within a given seniority class, may credibly threaten to block a value-maximising reorganisation unless they are paid a “bribe”, usually from the rightful share of creditors of a different class under the statutory distribution regime or claimants who do have a collateral stake.¹⁴⁷ To protect the interests of the creditors as a whole from inter- and intra-creditor opportunism, the decision-making mechanism under a formal rescue regime must be able to neutralise the effect of creditor strategic behaviour.

The main decision-making mechanism that the CO provides is the SOA provision under s 166. This provision protects creditors through its voting rules and the control power it confers on the courts. The rules that the courts have developed on the application of this provision help fill the gaps left in the SOA provision. The remainder of this section will start with a brief outline of the decision-making mechanism under s 166. It will then proceed to consider anti-opportunism properties of the SOA system. The creditor protection effect of the system will be considered in the light of the need for protecting creditors against inter-creditor rent-seeking behaviours and intra-creditor strategic behaviours.

1. Section 166 and Classification Rules

¹⁴⁵ R A. Posner, *Economics Analysis of Law* (Beijing, CITIC, 6th edn, 2003) 422; Quinn, *supra* n 143, 24.

¹⁴⁶ That is, claimants who do not have an interest in the survival of the company.

¹⁴⁷ Quinn, *supra*, n 143, 3-4.

As noted previously, s 166 is a collective decision-making procedure by which company creditors are able to reach an agreement to bind themselves *inter se*, and to the company, by a prescribed level of majority, to accept the proposed compromise plan. The required level of majority prescribed under s 166 is a majority in number representing three-quarters in value of the creditors or class of creditors, or members or class of members.

Upon court sanction,¹⁴⁸ the scheme will be binding on any dissenting minority, who may otherwise seek to wind up the company before the completion of a reorganisation plan. A proposal made under s 166 in Hong Kong cannot be sanctioned unless it is approved by each class through decisions made in their own class meetings.¹⁴⁹ This requirement is perceived as one of the difficulties relating to the provision.¹⁵⁰

The rationale behind the requirement of class meetings is to prevent the collective decision-making procedure from being exploited by strategic parties to benefit themselves at the expense of other scheme participants.¹⁵¹ The ways in which a class should be constituted is a difficulty that the courts in different jurisdictions have experienced when exercising their discretion in implementing a collective decision-making procedure.¹⁵² It appears to be widely believed that the lack of clear rules on classification renders SOA too complicated to deploy as a restructuring instrument.¹⁵³

As far as Hong Kong is concerned, this assessment of the utility of the SOA process has not borne out. The reality is that courts in Hong Kong have developed two classification rules

¹⁴⁸ On the rules on the sanction of a proposed s 166 scheme, see *supra* text to n 125 above.

¹⁴⁹ Tyler, *supra*, n 15, 761.

¹⁵⁰ Tyler, *supra*, n 15, 761.

¹⁵¹ *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 at 583 per Bowen LJ. Lopucki & Triantis, *supra* n 2, 171. See also the discussion below on the role of class meeting in controlling creditor opportunism against fellow creditors: *infra* note 170 and accompanying text.

¹⁵² See *supra*, n 2.

¹⁵³ See Finch, *supra*, n 2, 483. See also Tyler, *supra* n 2, 56; Smith, *supra* n (2) 245; Smart and Booth, *supra*, n 2, 487 (2001) (“the deficiency of the scheme of arrangement as a corporate rescue mechanism require no elaboration”); CD Booth, “Hong Kong insolvency law reform: preparation for the next millennium” (2001) *The Journal of Business Law* 126, 147-148; Booth et al, *supra*, n 2, 300-301.

that have proven to be effective. The first one, which can be termed the “common right” rule, states that SOA scheme participants are to be classified by dissimilarity of claimholders’ rights against the company, not dissimilarity of their individual interests.¹⁵⁴ The second one, which can be called the “exclusion rule”, states that members or creditors whose economic interests are not to be affected by the proposed scheme do not need to participate in the scheme.¹⁵⁵ Whether a class of creditors will have economic interests in a proposed scheme will need to be determined on the basis of a valuation report prepared by using appropriate methods.¹⁵⁶

In addition to providing guidance on classification, the common right rule and the exclusion rule perform two further functions. First, they resolve the difficulty associated with the requirement that a proposal be approved by each class of claims. A result of the application of the rules is that, in most cases, only a single class of claimholders need to participate in the proposed scheme.¹⁵⁷ Secured creditors and preferential creditors, for example, often only need to participate in their capacity as ordinary unsecured creditors to the extent that their claims as secured creditors and preferential creditors are not satisfied under the proposal.¹⁵⁸ Secondly, and more importantly, the rules have proven to be effective instruments to discipline strategic behaviours. This will be discussed further below.

¹⁵⁴ *In re Industrial Equity (Pacific) Ltd* [1991] 2 HKLR 614; *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] HKEC 1440.

¹⁵⁵ Thus where the proposed scheme involves a compromise with creditors who have recourse against both the borrowing company and the guarantor, which was the parent company of the borrower, it is unnecessary to include creditors who have recourse to the borrower but not the guarantor: *Re Jinro (HK) International Ltd* [2004] HKEC 519.

¹⁵⁶ *In Re Bluebrook Ltd* [2009] EWHC 2114 (Ch); [2010] BCC 209 (ChD), for example, Mr Justice Mann held that the valuation reports that were prepared by the scheme companies on a going concern basis could be used to determine the economic interests of subordinated creditors whereas the report prepared by the subordinated creditors was not good enough to establish what they sought to establish. The reason why the former was appropriate was that it was comprehensible and related to a real point, namely, how much a purchaser would pay for the corporate group. The latter, in contrast, was a mechanical and non-judgmental assessment, which was unsuitable in a case where a real world judgment as to what is likely to happen was called for.

¹⁵⁷ This is the position in all but one case where the proposed schemes have been sanctioned by the Hong Kong courts since the 1990’s. The only case where more than one class meetings were required is *Re Plus Holdings Ltd* [2008] HKEC 1327.

¹⁵⁸ For an example, see *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] HKEC 1440.

2. Inter-creditor Opportunism

Broadly, stakeholders' interests may be harmed by two types of inefficient decisions in the disposition of the debtor's assets. The first is the imposition of a non-value maximising reorganisation on dissenting stakeholders. The second is the blocking of an efficient reorganisation proposal.

The incentive for forcing an inefficient reorganisation on other stakeholders comes from what can be called "collateral interests."¹⁵⁹ The interests of certain categories of claimants are consistent with the continuing existence of the company. This class of claimants can include company officers and employees,¹⁶⁰ as well as suppliers and trade creditors. The liquidation of the company means that they will lose a valuable source of income. This category of creditors may therefore be induced to vote for a reorganisation proposal even though the value of their expected return is likely to be increased if the company is liquidated.¹⁶¹ It is possible for a non-value maximising reorganisation to be imposed on a certain *class* of claimants (such as secured creditors) by another *class* of claimants (who tend to be junior creditors), in which case the conflict is between members of different classes.¹⁶² Where the statutory decision-making mechanism requires the approval by claimants of different classes through class meetings, it is also possible for members who have collateral interests to force their will on non-approving members *within the same class*. Where the conflict is intra-class and voting is conducted on a head count basis, the difference in the size of stakes held by each claimant gives small holders more voting power than they are entitled to. Small claim

¹⁵⁹ Quinn, *supra*, n 143, 4.

¹⁶⁰ But note that, as mentioned in Section C above, because of the possibility of a PWIF payment where the company is wound up employees in Hong Kong tend not to have a collateral interest in an inefficient reorganization.

¹⁶¹ See Quinn, *supra* n 143, 4. See also Baird, *supra*, n 2, 327.

¹⁶² See Quinn, *supra* n 143, 5-6.

creditors, for example, may be willing to support a risky reorganisation proposal if they could compel a minority of large claimholders to contribute most of the capital.¹⁶³

A decision to block a value maximising reorganisation may be motivated by two different reasons. The first is the reverse of “collateral interests”. A category of claimants may prefer immediate liquidation to the reorganisation option because they would be financially better off if the company was immediately wound up. In Hong Kong, employees are a class of creditors whose interests may be consistent with immediate liquidation. As pointed out in section C,¹⁶⁴ when the company is wound up, the employees are entitled to a payout from PWIT, the size of which is much larger than their preferential entitlement under s 265 of the CO. Before a PWIT payment application is made, a winding-up petition must have been made against the employer company.¹⁶⁵ This is one of the reasons why winding-up petitioners in Hong Kong are often company employees and why employees tend to prefer the liquidation option. When the job market is good, employees are more willing to have the company wound up and obtain the PWIF payment rather than face the uncertainty of a reorganisation attempt.¹⁶⁶

A decision to block a value-maximising reorganisation can be motivated by the desire to bargain for a share of the debtor company’s assets that the claimant is not entitled to under the statutory distribution system, which generally requires that the claims of senior claimants be met before that of junior claimants.¹⁶⁷ For example, either junior or senior claimholders may threaten to block an efficient reorganisation plan unless they are paid a “bribe”.¹⁶⁸ Part

¹⁶³ See Quinn, *supra* n 143, 24.

¹⁶⁴ See *supra* n 28.

¹⁶⁵ Protection of Wages on Insolvency Ordinance 1985, s 16 (1) (b).

¹⁶⁶ Tang, *supra* n 10, 462.

¹⁶⁷ Quinn, *supra* n 143, 4. The irony in Hong Kong is that the desire to obtain a share of the debtor’s assets that a claimant is not entitled to under the statutory distribution system, where the claimant is an employee, is excited and supported by a different statutory rule – the provisions on PWIF.

¹⁶⁸ Quinn, *supra* n 143, 5.

of the incentive for small claim creditors to hold out for a “bribe” is that they, in any event, will have little to lose from an inefficient disposal of the debtor’s assets.¹⁶⁹ As in the case of forcing through an inefficient reorganisation, a hold out threat can also be made against the claimants of either creditors of a different class or claimholders within the same class. Where a hold out is aimed at claimants within the same class, unequal stakes can be used as device to obtain a positional advantage.

As pointed out above, one of the roles of a reorganisation decision-making mechanism is to protect stakeholders from the strategic behaviour of other creditors. In Hong Kong, the SOA procedure has proven to be effective in curtailing both types of strategic behaviours discussed above. This can be more clearly illustrated through a consideration of the impact of the statutory and court-developed rules on the various types of inter and intra class strategic behaviours.

3. Controlling Inter-class Opportunism

Under the SOA system, inter-class strategic behaviour can be effectively controlled by the class meeting requirements and court-made rules considered previously. Where one class of creditors attempts to impose a non-value maximising reorganisation on another (say secured creditors), the rule on class meetings, *prima facie*, serves to protect the latter category of claimants. The requirement that any SOA proposal must be approved by all class meetings ordered by the court¹⁷⁰ means that a proposal will be rejected if it fails to gain the approval of a single class (e.g. the class on which the opportunistic class threatens to impose an inefficient proposal).

¹⁶⁹ Quinn, *supra* n 143, 24.

¹⁷⁰ See *supra* n 149.

A class of claimants can also avoid being forced into an inefficient reorganisation if they do not need to participate in the proposed reorganisation scheme. The exclusion rule, for example, can help achieve this purpose. Under this rule, it will be remembered,¹⁷¹ there is no need for a class of claimants to be involved where the proposed scheme does not affect their rights or interests. Secured creditors who are able to realise the full value of their claims tend to be indifferent to the choice between liquidation and reorganisation. It is therefore not unfair to exclude them from a proposed reorganisation plan.

Where one class of claimants (typically employees in Hong Kong) threatens to block an efficient reorganisation, the class meeting requirement will not help, as the veto of a single class of claimants can block the proposal. In Hong Kong, a typical way of resolving the same problem is, in appropriate circumstances, refusing to treat the latter category of claimants as members of a separate class. This is done through the application of both the exclusion rule and the common right rule. The common right rule denies a class of strategic claimants the opportunity to block an efficient proposal. This is done by refusing to treat a category of claimants as a separate class just because they share common individual interests in a certain way of disposing the debtor's assets. As pointed out above, under the common right rule only claimants who share common rights against the company are to be treated as members of the same class.

Where the hold out claimants do share a common right against the company (e.g. where they are all preferential creditors), if their right is not affected under the proposed plan (e.g. if their claim as preferential creditors is to be fully satisfied under the plan), the exclusion rule dictates that they are to be excluded from participating in the proposed scheme. Any amount owed in excess of the maximum amount owed under s 265 of the CO (the preferential claim provision) can be treated as an ordinary unsecured claim, in which case the claimants are to

¹⁷¹ See *supra* text to n 155.

be classified as unsecured creditors.¹⁷² As the court-made classifications rules function to deny strategic claimholders the ability to block a value-maximising reorganisation proposal, they can be viewed as a form of “cram down” device,¹⁷³ to use a US jargon.¹⁷⁴

4. Policing Intra-class Strategic Behaviour

The above-mentioned advantage-taking strategies can also be employed by a group of strategic creditors against other claimholders within the same class. The majority of a class may be able to force a non-value-maximising reorganisation on the minority for the reasons considered previously (majority exploitation). Alternatively, a minority group that has enough votes can threaten to put the debtor company in liquidation, unless a “bribe” is paid (minority rent-seeking), even if reorganisation is a more beneficial option for the claimants as a whole.¹⁷⁵ In Hong Kong, this can happen where a group of employee creditors who vote as ordinary unsecured creditors (where full payment of their preferential claims are provided for under the proposed scheme) try to block an efficient reorganisation unless they are paid an amount equivalent to a PWIF payment. A creditor may also have an incentive to vote for an inefficient liquidation where the size of financial derivatives it holds means that it will be financially better off if the company goes into liquidation. An example is where a holder of the company’s bond also holds a short credit default swap (CDS) position, the size of which is considerably larger than the long position it holds.¹⁷⁶ Under a CDS arrangement, the

¹⁷² *Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] 3 HKLRD 634.

¹⁷³ “In Chapter 11, judges have extraordinary power to approve plans of reorganization that impose significant concessions on dissenting creditors, shareholders, and others. Colloquially, this power is called ‘cram down’”: J Friedman, “What Courts Do to Secured Creditors in Chapter 11 Cram Down” (1994) 14 *Cardoso Law Review* 1496, 1496.

¹⁷⁴ The function of the classification rules should be read together with the rules on the sanction of an SOA scheme: see *supra* text to nn 125-127.

¹⁷⁵ Quinn, *supra* n 143, 6.

¹⁷⁶ See H T C Hu & B Black, “Equity and Debt Decoupling and Empty Voting II: Importance and Extensions” (2007-2008) 156 *U Pa L Rev* 625, 728, 731.

holder of the long side of a CDS accepts default risk from the short side.¹⁷⁷ A creditor whose short CDS position is larger than its long position will profit more from its swap position than it will lose from his bonds if the company is liquidated.

Once again, voting rules, both statutory and decisional, function to neutralise the effect of advantage-taking strategy manoeuvred against members within the same class. Whilst inter-class majority exploitation can be frustrated by the class meeting requirement, intra-class majority advantage taking can be resolved by a different voting rule under s 166, namely, the supra majority rule. As the supra majority required for the approval of a proposal under s 166 is 75% in value of the total claims in each class,¹⁷⁸ a simple majority holding less than three-quarters of the claims will not be able to force an inefficient reorganisation on other members within the same class.

As pointed out previously, a group of small claimholders are able to make their strategic threat more credible as their relatively small stakes in the outcome of a proposed decision gives them more bargaining power than they are entitled to.¹⁷⁹ The main instrument that neutralises the voting power augmentation effect of unequal stakes under s 166 is the “weighted voting rule”, which allocates voting rights on the basis of the value held by each claimant. The requirement under s 166 that a proposed plan can only be sanctioned if, among other things, it is approved by three-quarters *in value* of each class or creditors is such a rule. One of the functions of this rule is, obviously, the alignment of a claimant’s voting power with the value of its claim. This rule helps prevent small claimholders from obtaining more bargaining power than they are entitled to according to the size of the stakes of their claims.

¹⁷⁷ Hu & Black, *supra* n 176, 728.

¹⁷⁸ Section 166(2), CO.

¹⁷⁹ See *supra* text to n 163.

Quinn points out that while the weighted voting rule is effective in policing the unequal stakes problem within unsecured and preferential creditors it has limited value to regulate the same problem within secured creditors. Quinn's point is that a claimant's voting power under the weighted voting rule is based on the face value of its claim, as distinguished from the economic value. The face value is only identical to the economic value of a claim when it is possible to realise the full value of the underlying security. Where the underlying assets are worth less than the face value of a claim, the claimant is able to exercise more voting power than it is entitled to, even under the weighted voting rule.¹⁸⁰

Under the SOA system, although the unequal stakes problem within the class of secured creditors cannot be resolved by any of the statutory voting rules, the problem referred to in the preceding paragraph appears to have been successfully policed by the exclusion rule and common right rule, discussed previously. Under the former rule, there is no need for the holders of fully realisable claims to participate in a proposed reorganisation plan, as their interests will not be affected by the reorganisation.¹⁸¹ Under the latter rule, a secured creditor may participate in the proposed scheme in the same class as unsecured creditors with regard to the portion of its claim that cannot be met by the proceeds resulting in a realisation of its security interest.¹⁸² The holder of a claim the face value of which is greater than its economic value therefore will have no opportunity to exercise a voting power that is greater than it is entitled to.

5. The Suitability of the SOA Decision-making Mechanism for Hong Kong

¹⁸⁰ Quinn, *supra* n 143, 25.

¹⁸¹ *Re UDL Holdings Ltd* [2000] HKEC 429; *Re Interform Ceramics Technologies Ltd* [2001] HKEC 469; *Re Dickson Group Holdings Ltd* [2008] HKEC 899.

¹⁸² *Re UDL Holdings Ltd* [2000] HKEC 429; *Re Dickson Group Holdings Ltd* [2008] HKEC 899.

Given the social conditions in Hong Kong, the need for protecting workers must be taken into consideration in designing the collective decision-making apparatus in a formal rescue system. The treatment of the employees laid off during the reorganisation should not be treated less favourably than in wound up.¹⁸³ The class meeting requirement under s 166 has functioned effectively in achieving this purpose. This is demonstrated in *Re S Megga Telecommunications Ltd*,¹⁸⁴ where the court refused to sanction a scheme on the ground that no separate class meeting had been constituted for employees where it was not shown that the workers' preferential claims were to be fully satisfied under restructuring plan.

It may be possible to achieve the same purpose under a decision-making mechanism that only provides for a single class meeting by giving employee votes more weight.¹⁸⁵ It will however be extremely difficult, if not impossible, to develop a rule on the weight that should be given to employee votes that is applicable to all situations. The SOA procedure is able to determine the employees' decision-making power in a structured manner. Where the proposed reorganisation plan does not guarantee the full satisfaction of workers' preferential claims, the employees are to be constituted into a separate class and vote accordingly. The voting rules prescribed in s 166 regulate intra-class strategic behaviour.

Where the restructuring plan guarantees the full preferential payments to the workers, the court-developed classification rules dictate that no separate meeting needs to be constituted for employees. The difference between the actual amount owed to an employee and that of his or her preferential claim is to be treated as an unsecured debt and the workers vote with other unsecured creditors. Again, the SOA voting rules neutralise the effect of possible strategic voting by employees in the meeting of unsecured creditors.

¹⁸³ Financial Services and Treasury Bureau, *Review of Corporate Rescue Procedure Legislative Proposals: Consultation Paper* (Oct 2009), accessed on 12 Aug 2011: www.fstb.gov.hk, 22.

¹⁸⁴ [2002] HKEC 1344.

¹⁸⁵ See comments made by Wong, *supra* n 35, para.21.

The class meeting requirement under the SOA procedure does not mean that in all circumstances, a decision must be made through more than one class meetings. As mentioned previously, thanks to the operation of the classification rules, most of the SOA restructuring proposals sanctioned by the Hong Kong courts have entailed just a single class meeting.¹⁸⁶ In other words, the classification rules make it possible to shape the collective decision-making structure according to the needs arising from different circumstances. The clarity and simplicity of the classification rules means that the decision-making device can be deployed at low cost and with a high degree of ease.

H. THE WAY FORWARD

The discussion so far demonstrates that the SOA system provides a flexible reorganisation control mechanism as well as an effective collective decision-making structure. The less satisfactory aspect of the system is its stay apparatus. The complexity of the procedures and rules on stay applications under the existing system means that considerable energy, time, and resources may need to be spent on the achievement of a moratorium. A simplified stay procedure will allow the management to focus on the preparation of the scheme plan and the coordination of the rescue process.

The simplest way of streamlining the stay process under the current SOA system is to give the court the power to order a stay for the purpose of s 166. In its 1996 *Report on Corporate Rescue and Insolvent Trading*, the LRC rejected a proposal to link a moratorium to s 166 on the ground that doing so would create a Chapter 11 style DIP regime.¹⁸⁷ Linking a stay mechanism to s 166 does not however create a Chapter 11 DIP regime if the mechanism does

¹⁸⁶ See *supra* n 157.

¹⁸⁷ The Law Reform Commission of Hong Kong, *Report on Corporate Rescue and Insolvent Trading* (October 1996) 8.

not provide for an automatic stay. What this article proposes is to link a court-controlled stay to s 166.

As was pointed out in section E above, a DIP mode of control is desirable for effecting a rehabilitative rescue, provided that there are means to police the strategic behaviours on the part of prepetition management.¹⁸⁸ The court control over the stay mechanism is an effective tool for disciplining debtor opportunism. This has been proven by not only the Hong Kong courts' experience in granting stays through various means discussed previously,¹⁸⁹ but also the experience in Singapore, where SOA have been used as the chief restructuring procedure.¹⁹⁰ The SOA provision in Singapore's Companies Act (CA (Sing)), which is of Australian lineage,¹⁹¹ makes specific provisions to deal with the inadequacy of the British version of SOA. Section 210 (10) of CA (Sing) confers the power on the court to order a stay on the application of the body, its creditors or shareholders.¹⁹² Singapore's experience in facilitating corporate rescue through SOAs appears to be particularly successful, partly due to the stay mechanism provided in its SOA provision.¹⁹³

To prevent the stay mechanism from being abused, the courts in jurisdictions where the SOA provision is also of Australian lineage¹⁹⁴ have developed rules governing the court's discretion in granting a stay for the purpose of the SOA provision. Thus, the court will be reluctant to grant a stay unless the debtor can demonstrate the existence of a genuine restructuring proposal with sufficient particulars to enable the court to assess that it is feasible and merits due consideration by creditors (although not necessarily ready for presenting to

¹⁸⁸ See *supra* text to nn 43-44 above.

¹⁸⁹ See *supra* Section F.

¹⁹⁰ See Lee, *supra*, n 6, 339.

¹⁹¹ A Chan (ed), *Law and Practice of Corporate Insolvency* (Singapore, LexisNexis, 2005), [750].

¹⁹² Companies Act (Sing), s 210 (1); See also Chan, *supra* n 6, 42.

¹⁹³ See Lee, *supra*, n 6, 338-341.

¹⁹⁴ These also include Malaysia.

creditors for a vote).¹⁹⁵ The genuineness of the proposal can be established by showing, for example, that the debtor has already commissioned corporate turnaround professionals who have directed their minds to the putting up of the scheme,¹⁹⁶ or by evidence on the process of preparation of the documentation and the discussion of the creditors.¹⁹⁷

As the interim stay mechanism attached to an SOA procedure has proven to be effective in facilitating corporate rescue in other jurisdictions,¹⁹⁸ there are no policy or doctrinal reasons why a similar stay arrangement cannot or should not be made in Hong Kong in relation to s 166. The jurisprudence already developed on the operation of the stay mechanism linked to a SOA provision can provide guidance on the utilisation of such a mechanism.

I. CONCLUSION

The greatest advantage of the SOA system over a PIP regime such as Administration, VA, or PS is that it can operate in a DIP mode when warranted by the circumstances. The device through which the mode of reorganisation control for the SOA system is determined is the SOA stay mechanism. As the moratorium linked to s 166 will also be court controlled, the suggested reform of s 166 will not change the nature of the corporate control structure under the SOA system.

As it is court led, this stay mechanism can be costly, although the reform proposed by this paper will reduce that cost. The expense for this type of moratorium, however, can be seen as a price that the society needs to pay for a flexible reorganisation control regime. If leaving pre-petition management in charge of the debtor's reorganisation under Chapter 11 is a 'tax'

¹⁹⁵ *Re Kuala Lumpur Industries Bhd* [1990] 2 MLJ 180 at 182.

¹⁹⁶ *Re Kuala Lumpur Industries Bhd* [1990] 2 MLJ 180 at 183.

¹⁹⁷ *Playcorp Pty Ltd v Venture Stores (Retailers) Pty Ltd* (1992) 7 ACSR 193 at 198.

¹⁹⁸ See Lee, *supra*, n 190, 338-341; Chan, *supra*, n 192.

that needs to be paid to the managers for the advantages of a DIP regime,¹⁹⁹ the cost for a court-led stay mechanism can be seen as a tax that must be paid for a more flexible DIP regime under the SOA system. The extent to which the merit of the SOA system can be questioned on the ground of cost is therefore debatable. As the SOA system is not blocked by the bottleneck that prevents operation of the proposed PS, a reform of the SOA system is a realistic way of providing Hong Kong with a more effective corporate rescue regime, at least before the PS bottleneck can be uncorked.

¹⁹⁹ See Hahn, *supra*, n 41, 141.

Appendix I: The Surveyed Cases

Re 3D-Gold Jewellery Holdings Ltd [2009] HKEC 1104 CFI

Re APP (Hong Kong) Ltd [2005] HKEC 1583

Re Beauforte Investors Corp Ltd [2008] HKEC 1003

Re CIL Holdings Ltd [2003] HKEC519

Re Dickson Group Holdings Ltd [2008] HKEC 899

Re Fujian Group [2003] HKEC 1481

Re I-China Holdings Ltd [2004] HKEC 505

Re Interform Ceramics Technologies Ltd [2001] HKEC 469

Re Jinro [2004] HKEC 937

Re Kosonic Industries Ltd Ltd [1999] HKEC 1183

Re Merchants (Hong Kong) Ltd [2005] HKEC 594

Re Music Trading On-Line (HK) Ltd [2008] HKEC 2110

Re Ocean Grand Holdings Ltd [2008] HKEC 664;

Re Perfect Sense Group Ltd [2007] HKEC 966;

Re Plus Holdings Ltd [2008] HKEC 1327

Re RCR Electronics Manufacturing Ltd [1998] HKEC 261

Re Sun Motor Industrial Co Ltd [2008] HKEC 2006

Re Seapower Resources International Ltd [2003] HKEC 1372

Re Sharp Brave Co Ltd [1999] HKEC 368

Re Stereo Ltd [2005] HKEC 1085

Re Tai Kam Construction Engineering Co Ltd [2005] HKEC 507

Re Team Concepts Manufacturing Ltd [2001] 3 HKLRD K7

UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin [2001] 3 HKLRD 634

Re Wah Nam Group Ltd [2002] HKEC 1090

Re Yaohan Hong Kong Corp Ltd [2001] 1 HKLRD 363

Re Yetyue Ltd [2001] HKEC 1156

Re Zhu Kuan (Hong Kong) Co Ltd [2007] HKEC 1947

Re Beauty China Holdings Ltd [2009] HKEC 1499

Re Cheery City Contractors Ltd [2004] HKEC 504

Re China Motor Vehicle Economic Development Co Ltd [2000] HKEC 61

Re CIL Holdings Ltd [2002] HKEC 97

Credit Lyonnais v SK Global Hong Kong Ltd [2003] HKEC 963

In the Matter of Gold-Face Holding Ltd [2006] HKEC 1795

Re Golden Dragon Land Development Ltd [1999] 3 HKLRD J4

Re Greater Beijing First Expressways Ltd [2000] HKEC 651

Re Hong Kong Brewing & Restaurants Ltd [1999] HKEC 637

Re King Pacific International Holdings Ltd [2002] 3 HKLRD 474.

Re Koldtech Development (International) Ltd [2005] HKEC 1190

Re Luen Fai Picergoods & Cloths Co Ltd [2010] HKEC 323

Re MBf Asia Capital Corp Ltd [2000] HKEC 1041

Re Plus Holdings Ltd [2007] 2 HKLRD 725

Re RNA Holdings 2004WL 2154047 [2004] HKEC 1265

Re S Megga Telecommunications Ltd [2002] HKEC 1344

Re Tse Yu Hong Ltd [1999] HKEC 1048

Re UDL Holdings Ltd [1999] 2 HKLRD 817

Re UDL Holdings Ltd [2000] HKEC 429 CFI

Re RNA Holdings [2005] HKEC 1372

Re APP (Hong Kong) Ltd [2004] HKEC 522

Re UDL Holdings Ltd [2001] 1 HKLRD 156 (CA) ('Case 3')

UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin [2001] 3 HKLRD 634

Re Wah Lee Resources Holdings Ltd [2002] HKEC 1115

Re X10 Ltd [1989] HKLY 108

Re Albatronics (Far East) Co Ltd [2002] 2 HKLRD F6

Appendix II: Sanctioned Cases

**Re 3D-Gold Jewellery Holdings Ltd* [2009] HKEC 1104 CFI

Re APP (Hong Kong) Ltd [2005] HKEC 1583

Re Beauforte Investors Corp Ltd [2008] HKEC 1003

Re CIL Holdings Ltd [2003] HKEC519

**Re Dickson Group Holdings Ltd* [2008] HKEC 899

**Re Fujian Group* [2003] HKEC 1481

**Re I-China Holdings Ltd* [2004] HKEC 505

**Re Interform Ceramics Technologies Ltd* [2001] HKEC 469

**Re Jinro* [2004] HKEC 937

Re Kosonic Industries Ltd Ltd [1999] HKEC 1183

**Re Merchants (Hong Kong) Ltd* [2005] HKEC 594

**Re Music Trading On-Line (HK) Ltd* [2008] HKEC 2110

**Re Ocean Grand Holdings Ltd* [2008] HKEC 664;

Re Perfect Sense Group Ltd [2007] HKEC 966

**Re Plus Holdings Ltd* [2008] HKEC 1327

In the Matter of RCR Electronics Manufacturing Ltd, and In the Matter of the Companies Ordinance, Chapter 32 [1998] HKEC 261

Re Sun Motor Industrial Co Ltd [2008] HKEC 2006

**Re Seapower Resources International Ltd* [2003] HKEC 1372

Re Sharp Brave Co Ltd [1999] HKEC 368

Re Stereo Ltd [2005] HKEC 1085

**Re Tai Kam Construction Engineering Co Ltd* [2005] HKEC 507

Re Team Concepts Manufacturing Ltd [2001] 3 HKLRD K7

UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin [2001] 3 HKLRD 634

**Re Wah Lee Resources Holdings Ltd* [2002] HKEC 1115;

**Re Wah Nam Group Ltd* [2002] HKEC 1090

**Re Yaohan Hong Kong Corp Ltd* [2001] 1 HKLRD 363

Re Yetyue Ltd [2001] HKEC 1156

**Re Zhu Kuan (Hong Kong) Co Ltd* [2007] HKEC 1947

*Cases where the restructuring was managed by IPs.