



# ICLG

The International Comparative Legal Guide to:

## Corporate Recovery & Insolvency 2018

**12th Edition**

A practical cross-border insight into corporate recovery and insolvency work

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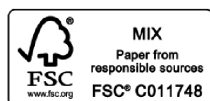
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# Hong Kong



Nick Gall



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## 1 Overview

### 1.1 Where would you place your jurisdiction on the spectrum of debtor to creditor-friendly jurisdictions?

Hong Kong's insolvency regime, like its commonwealth counterparts, has always been very creditor-friendly. In the right circumstances, courts even have the power to exercise their discretion to wind up foreign companies. Although the statutory rescue procedure under the Companies Ordinance of Hong Kong by way of a scheme of arrangement is designed to provide a debtor company with more control than the traditional insolvency proceedings, the scheme is still required to be approved by the company's creditors and the court.

### 1.2 Does the legislative framework in your jurisdiction allow for informal work-outs, as well as formal restructuring and insolvency proceedings, and to what extent are each of these used in practice?

The Companies Ordinance of Hong Kong provides for the following formal restructuring and insolvency procedures for companies in financial difficulties:

- (1) a members' voluntary liquidation;
- (2) a creditors' voluntary liquidation;
- (3) a compulsory liquidation;
- (4) appointment of a receiver; and
- (5) a scheme of arrangement.

In practice, most restructurings take place by way of informal work-outs, compositions and arrangements essentially made by agreement of the parties concerned.

## 2 Key Issues to Consider When the Company is in Financial Difficulties

### 2.1 What duties and potential liabilities should the directors/managers have regard to when managing a company in financial difficulties? Is there a specific point at which a company must enter a restructuring or insolvency process?

#### General/Common Law Duties

As a general rule, the director of a company has certain fiduciary duties towards the company and its members. However, as a

company approaches insolvency, a director has a duty to take into account the interests of the company's creditors. If he/she breaches those duties, he/she may be ordered to compensate the company for any loss or damage that has been suffered as a result of those breaches or repay, restore or account for the money or property appropriated or acquired.

#### Misfeasance

Where a director has breached his duties to the company by misapplying or retaining any money or property, the court can compel repayment of money or restoration of property or contribution by way of compensation by that director.

#### Fraudulent Trading

A director may be personally liable if he/she was knowingly involved in carrying on any business of the company with the intent to defraud its creditors. The court may make an order that the director be personally liable for all or any of the debts and liabilities of the company. He is also exposed to criminal liability and potentially liable to a fine and imprisonment.

#### Disqualification

A director may be disqualified for a period of up to 15 years if he/she: engages in fraudulent trading; is unfit to be concerned in the management of a company; is convicted of an indictable offence in connection with the promotion, formation, management, or liquidation of any company such as falsifying company's books; or is found guilty of any other misconduct in relation to the company.

Whether or not a company must enter a restructuring or insolvency process will depend on various factors, including whether it is solvent or not. A solvent company will be able to restructure using schemes of arrangement at any time.

### 2.2 Which other stakeholders may influence the company's situation? Are there any restrictions on the action that they can take against the company? For example, are there any special rules or regimes which apply to particular types of unsecured creditor (such as landlords, employees or creditors with retention of title arrangements) applicable to the laws of your jurisdiction?

#### Insolvency

In a creditors' voluntary liquidation and a compulsory liquidation, generally the creditors have the most significant influence on the company's situation. In a compulsory liquidation, the creditors initiate the process and are also responsible for nominating and voting for the appointment of a liquidator, and a committee of inspection to supervise the liquidator in the conduct of the liquidation. In a

creditors' voluntary liquidation, the liquidator nominated by the creditors will normally prevail in the event of a conflict with the liquidators appointed by the shareholders and creditors.

Secured creditors stand outside the liquidation as they are generally entitled to be paid out of the proceeds of their security ahead of all other claims.

Unsecured creditors have limited rights in any liquidation as they are ranked the lowest amongst all creditors. An unsecured creditor would not rank higher than other creditors even if leave was granted in his favour to proceed with or commence an action against the company in compulsory liquidation and that action was ultimately successful.

A landlord would not be allowed to distrain for rent due before the winding up commenced in respect of which he is a creditor of the company, but will need to prove his debt.

Employees would be considered unsecured creditors of the company, except in respect of any statutory claims arising under the Companies Ordinance, which would constitute preferential debts.

Creditors with lien would have the right to hold the assets of the debtor, although this right would not generally extend to the power of sale (which should be sought from the Court).

Generally, an unpaid vendor with a retention of title arrangement would be entitled to retain possession of goods which he has sold but not delivered to an insolvent purchaser.

#### Restructuring

In a restructuring (whether formal or not), it is again the creditors who have the most significant influence on the company's situation.

As there are no provisions of moratorium, the fact that a company is in the process of restructuring does not prevent an individual creditor from suing the company, seizing the company's property or presenting a winding up petition.

### **2.3 In what circumstances are transactions entered into by a company in financial difficulties at risk of challenge? What remedies are available?**

#### Transactions at an Undervalue and Unfair Preferences

A transaction at an undervalue takes place when the company makes a gift or enters into a transaction with a person without receiving any consideration, or enters into a transaction for a consideration, the value of which is significantly less than the value of the consideration provided by the company. The liquidator may challenge the validity of any such transactions which took place five years prior to the commencement of the winding up.

An unfair preference occurs where a payment has been made by the company to a creditor when it is insolvent, but before the commencement of its winding up, with the effect of putting the creditor in a better position than it would otherwise have been in the liquidation of the company. The liquidator may challenge the validity of any such transactions which took place two years prior to the commencement of the winding up if the creditors are 'associates' (e.g. director or employee) or six months for any other creditor. If the challenge is successful, the court may restore the position to what it would have been if the company had not entered into the relevant transaction.

#### Extortionate Credit Transaction

The court may set aside any extortionate credit transactions entered into three years before the commencement of a voluntary winding up, the date on which a special resolution was passed to wind up the company or on the date of the winding up order made by the court.

A transaction will be considered extortionate if, having regard to the risk accepted by the person providing the credit, the terms require grossly exorbitant payments in respect of the provision of credit or grossly contravene ordinary principles of fair dealing.

#### Fraudulent Conveyance

Every disposition of the company's property made with the intent to defraud the creditors is voidable and may be set aside by the court. The exceptions are those made in good faith for valuable consideration and without notice of the intent to defraud creditors. The transfer of property must have been made with the deliberate intention of trying to put the company's assets beyond the reach of the creditors. The court may infer an intention to defraud in circumstances where the transaction was for little or no consideration.

#### Floating Charges

A floating charge created in favour of a person who is connected with the company two years prior to the commencement of a winding up will be invalid unless the company was solvent immediately after the charge was created or new consideration was provided for the charge. For floating charges created in favour of persons who are not connected with the company, the relevant clawback period is 12 months.

#### Disposition of Property after Presentation of Petition and Transfers after Commencement of Voluntary Winding Up

In a compulsory liquidation, any disposition of the company's property (including transfer of shares) after a winding up petition is presented, will be void, unless otherwise approved by the court. The court may make a validating order where a proposed sale of a company's assets would be beneficial not only for the company but also for its secured creditors. However, if the transaction involves an arrangement between a number of classes of creditors and the company, it will be wrong for the court to grant the order.

In a voluntary liquidation, any transfer of shares (other than transfer made to or with the sanction of the liquidators) and any alteration in the status of the members of the company after the commencement of a voluntary winding up, will be void, unless it was made with the sanction of the liquidator.

## **3 Restructuring Options**

### **3.1 Is it possible to implement an informal work-out in your jurisdiction?**

Yes. Most restructurings in Hong Kong take place by way of informal work-outs, compositions and arrangements essentially made by agreement of the parties concerned.

### **3.2 What formal rescue procedures are available in your jurisdiction to restructure the liabilities of distressed companies? Are debt-for-equity swaps and pre-packaged sales possible? To what extent can creditors and/or shareholders block such procedures or threaten action (including enforcement of security) to seek an advantage? Do your procedures allow you to cram-down dissenting stakeholders?**

There are no formal procedures available to achieve a restructuring of the company's debts in Hong Kong. The only exception is a scheme of arrangement. The Companies Ordinance of Hong Kong provides for procedures for court-sanctioned schemes of arrangements which may be entered into by a company with its creditors or members, or both and for companies' amalgamation (as among group companies).



A debt-for-equity swap arrangement may form part of a restructuring of a company. This will generally involve the dilution or elimination of existing shareholders' equity in the company.

Unlike many jurisdictions, there are no statutory provisions on pre-packaged insolvencies in Hong Kong, or any arrangement whereby the business of the company is carried on under a new and separate special corporate vehicle. That said, it is nevertheless not uncommon for companies to be restructured under a pre-packaged arrangement.

The fact that a company is in the process of negotiating a work-out or putting in place a scheme of arrangement does not prevent an individual creditor from suing the company, seizing the company's property or presenting a winding up petition. Some (often smaller) creditors will deliberately take such actions once they know:

- (a) they are not getting a better deal from the proposed scheme of arrangement or even paid off in full; and
- (b) that major creditors are in favour of the scheme of arrangement.

The only way of cramming down dissenting creditors is in a sanctioned scheme of arrangement. If a scheme of arrangement is sanctioned by the court, it becomes binding on all creditors and, as a result, the rights of creditors may change. Until that point, however, unsecured creditors may take any enforcement actions available to them against the company.

### 3.3 What are the criteria for entry into each restructuring procedure?

There are no specific criteria to be met by a company before negotiating a work-out or a scheme of arrangement. That being said, restructuring arrangements have to be agreed by, and made binding on, all creditors, otherwise a dissenting creditor may frustrate the rescue plan and petition for a winding up.

### 3.4 Who manages each process? Is there any court involvement?

A work-out is managed by the creditor(s) and the management of the company.

On the contrary, a scheme of arrangement is substantially supervised by the court, although the management of the company remains in place throughout the restructuring process. Once a proposal has been devised and presented to the shareholders and creditors, an application is made to the court to convene meetings of the respective classes of shareholders and creditors.

After the court makes an order that the meetings of the respective classes of creditors and shareholders can be convened, notice of the date and time of these meetings is advertised. At these meetings: (a) a majority of 75 per cent in value; and (b) 50 per cent in number is required to approve the proposed scheme.

After approval, a petition for sanction must be issued and, at the hearing of such petition, the court will consider whether or not to sanction the scheme. If the scheme is sanctioned by the court, a copy of the relevant court order must be filed with the Companies Registry in Hong Kong.

### 3.5 What impact does each restructuring procedure have on existing contracts? Are the parties obliged to perform outstanding obligations? Will termination and set-off provisions be upheld?

A work-out or a scheme of arrangement has no effect on the

contracts of a company. The insolvency regime in Hong Kong does not provide for any set-off in schemes of arrangements.

### 3.6 How is each restructuring process funded? Is any protection given to rescue financing?

A consensual restructuring on an informal basis can be achieved through a debt-for-equity swap, which involves the creditors exchanging some or part of their debt for shares in the company, the issuance of convertible notes at a low rate of interest with an option of converting into shares, and/or through 'white knight' investors.

Currently, there is no legislation granting any protection to rescue financing.

## 4 Insolvency Procedures

### 4.1 What is/are the key insolvency procedure(s) available to wind up a company?

The key insolvency procedures available to wind up a company are as follows:

- (1) a members' voluntary liquidation (it should be noted that this is a solvent liquidation);
- (2) a creditors' voluntary liquidation; and
- (3) a compulsory liquidation.

### 4.2 On what grounds can a company be placed into each winding up procedure?

A members' voluntary liquidation is only available where the company is solvent. Having made a full inquiry into the company's affairs, the directors must have also formed an opinion that the company will be able to pay all its debts within 12 months of the commencement of the winding up and sign a certificate of solvency to that effect. The shareholders must also pass a special resolution to wind up in a General Meeting.

A creditors' voluntary liquidation will occur where the company decides to place itself into voluntary liquidation but the directors are unable to certify the solvency of the company (i.e. the company is insolvent), or the liquidator is at any time of the opinion that the company will not be able to pay its debts in full within the specified period.

A compulsory winding up order may be made by the court where:

- (1) the company has passed a special resolution for winding up by the court;
- (2) the company has failed to commence its business within one year from its incorporation, or suspends its business for a whole year;
- (3) the company has no members;
- (4) the company is unable to pay its debts as and when they fall due;
- (5) the event, if any, occurs if the memorandum and articles provide that the company is to be dissolved; or
- (6) the court is of the opinion that it is just and equitable that the company be wound up.

### 4.3 Who manages each winding up process? Is there any court involvement?

A voluntary liquidation is managed by the directors of the company until the appointment of the liquidator.

A compulsory winding up is commenced by issuing a petition against the company. The court will hear the petition and make an order for compulsory winding up if it is satisfied that grounds for winding up have been established. It is managed by a provisional liquidator, Official Receiver or the liquidator, as the case may be.

#### 4.4 How are the creditors and/or shareholders able to influence each winding up process? Are there any restrictions on the action that they can take (including the enforcement of security)?

On the appointment of a liquidator in a members' voluntary liquidation, all the powers of the directors cease, although a liquidator or the shareholders in a General Meeting can sanction their continuance. Similarly, in a creditors' voluntary liquidation, the powers of the directors will also cease. However, the committee of inspection or, if there is no committee, the creditors, can sanction their continuance. In contrast, appointments of directors, agents and employees are automatically terminated when the court makes a winding up order under a compulsory winding up.

The rights of the shareholders will also lapse, although it is worth noting that the shareholders may still vote in a General Meeting for the continuance of the directors' powers in a members' voluntary liquidation.

Unsecured creditors have limited rights in any liquidation as they are ranked the lowest amongst all creditors. When a winding up order has been made or a provisional liquidator has been appointed, creditors must seek leave from the court to continue with, or commence proceedings against, the company. An unsecured creditor would not be ranked higher than other creditors even if leave was granted in his favour to proceed or commence an action against the company in compulsory liquidation and the action is successful.

On the other hand, secured creditors stand outside the liquidation as they are entitled to be paid out of the proceeds of their security ahead of all other claims. That said, if the security created is a floating charge, the preferential debts (e.g. sums owing to employees and the government) must be paid before the floating charge holder.

#### 4.5 What impact does each winding up procedure have on existing contracts? Are the parties obliged to perform outstanding obligations? Will termination and set-off provisions be upheld?

See the answer to question 2.3 above in respect of avoidance of disposition of property after a presentation of petition and avoidance of transfers after commencement of a voluntary winding up. As explained in question 2.3 above, the liquidator also has the power to avoid or set aside certain transactions to 'clawback' assets of the company in order to increase the funds available to distribute to creditors.

Set-off applies in liquidation where there have been mutual credits or mutual debts or other mutual dealings between the company and the creditor before a winding up order is made.

#### 4.6 What is the ranking of claims in each procedure, including the costs of the procedure?

The order of payment in a liquidation is generally as follows:

- (1) expenses of the winding up, including the liquidator's remuneration. The order of priority of the costs in a winding up is set out in rule 179 of the Companies (Winding up) Rules (Cap. 32H);

- (2) preferential debts;
- (3) any preferential charge on distrained goods;
- (4) the company's general creditors; and
- (5) shareholders.

#### 4.7 Is it possible for the company to be revived in the future?

In a voluntary liquidation, the company will be permanently dissolved three months after the liquidator files the final account and return with the Companies Registry in Hong Kong following the final meeting of creditors.

In a compulsory winding up, the liquidator can apply to the court for an order to permanently dissolve the company once the affairs of the company have been completely wound up. Dissolution brings the company to an end.

## 5 Tax

#### 5.1 What are the tax risks which might apply to a restructuring or insolvency procedure?

If the company continues to trade or sells its assets, it would be subject to tax on its profits.

## 6 Employees

#### 6.1 What is the effect of each restructuring or insolvency procedure on employees?

##### Restructuring

A work-out or a scheme of arrangement has no effect on employees.

##### Insolvency

On a compulsory winding up, all employment contracts will be automatically terminated, unless the court orders otherwise. On the other hand, the commencement of a voluntary liquidation does not automatically terminate the service contracts of employees. In the event an employee's contract is terminated, that employee becomes a preferential creditor of the company in respect of their unpaid wages, severance payments, etc. They could expect to receive *ex gratia* payments out of the Hong Kong Protection of Wages on Insolvency Fund if the company which employed them was put into liquidation.

## 7 Cross-Border Issues

#### 7.1 Can companies incorporated elsewhere use restructuring procedures or enter into insolvency proceedings in your jurisdiction?

Whilst the United Nations Commission on International Trade Law (UNCITRAL) has adopted the Model Law on Cross-Border Insolvency, there are no statutory provisions in Hong Kong to implement the UNCITRAL Model Law. Notwithstanding this, a foreign liquidator may initiate a new liquidation in Hong Kong against the foreign company. However, the court will only exercise its discretion to make a winding up order against a foreign company if, amongst other requirements, there is sufficient connection within the jurisdiction of Hong Kong.

### 7.2 Is there scope for a restructuring or insolvency process commenced elsewhere to be recognised in your jurisdiction?

A foreign liquidator may be able to protect assets of a foreign debtor in Hong Kong where the foreign winding up order is extraterritorial (i.e. extends to assets situated in Hong Kong) and is fair (i.e. does not depart from the *pari passu* rule for treating all creditors equally). In order to achieve this, the foreign liquidator may commence proceedings in Hong Kong seeking a declaration regarding the effect of the foreign insolvency proceedings and to recover debts.

### 7.3 Do companies incorporated in your jurisdiction restructure or enter into insolvency proceedings in other jurisdictions? Is this common practice?

Although it is common for Hong Kong companies to have assets and operations elsewhere, there are obvious difficulties in dealing with insolvencies of such companies in jurisdictions other than Hong Kong, especially while safeguarding and realising the assets.

## 8 Groups

### 8.1 How are groups of companies treated on the insolvency of one or more members? Is there scope for co-operation between officeholders?

Hong Kong does not have the concept of a group liquidation. Generally, in a winding up of a group company/companies, each company of the group is treated as a separate legal entity and the interest of a single company is not sacrificed for the larger interest of the group. To secure co-operation and also for practical reasons, the court may permit the same liquidator to take control of insolvent companies within a group, subject to any conflict of interest.

## 9 Reform

### 9.1 Have there been any proposals or developments in your jurisdiction regarding the use of technology or reducing the involvement of the courts in the laws of your jurisdiction, which are intended to make insolvency processes more streamlined and efficient?

The Companies Amendment Ordinance which came into effect in February 2017 introduces significant amendments to streamline the winding up process, including allowing the liquidator to communicate electronically with creditors and members of the committee of inspection, allowing the committee of inspection members to attend meetings remotely, allowing for costs/charges of liquidator-appointed agents to be approved by the committee of inspection without taxation, enabling the liquidator to appoint a solicitor without court sanction by giving seven days' notice to the committee of inspection, or alternatively where there is no committee of inspection, to the creditors, and most importantly, prescribing a form of statutory demand to help avoid disputes over validity of the demand.

### 9.2 Are there any other governmental proposals for reform of the corporate rescue and insolvency regime in your jurisdiction?

The key proposals for reform in the current insolvency regime include, *inter alia*, the introduction of:

- (1) provisional supervision rescue provisions for companies with minimum court involvement;
- (2) a moratorium on creditors' claims;
- (3) provisions relating to payment of outstanding wages and benefits to employees; and
- (4) stringent provisions for insolvent trading in order to encourage directors to initiate provisional supervision at an early stage.

The above proposed reforms have not been included in the Amendment Ordinance and it, therefore, remains to be seen whether these changes will be brought about in Hong Kong's insolvency regime in the near future.

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- Business Crime
- Cartels & Leniency
- Class & Group Actions
- Competition Litigation
- Construction & Engineering Law
- Copyright
- Corporate Governance
- Corporate Immigration
- Corporate Investigations
- Corporate Recovery & Insolvency
- Corporate Tax
- Cybersecurity
- Data Protection
- Employment & Labour Law
- Enforcement of Foreign Judgments
- Environment & Climate Change Law
- Family Law
- Fintech
- Franchise
- Gambling
- Insurance & Reinsurance
- International Arbitration
- Lending & Secured Finance
- Litigation & Dispute Resolution
- Merger Control
- Mergers & Acquisitions
- Mining Law
- Oil & Gas Regulation
- Outsourcing
- Patents
- Pharmaceutical Advertising
- Private Client
- Private Equity
- Product Liability
- Project Finance
- Public Investment Funds
- Public Procurement
- Real Estate
- Securitisation
- Shipping Law
- Telecoms, Media & Internet
- Trade Marks
- Vertical Agreements and Dominant Firms



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