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Global Restructuring & Insolvency Guide

Hong Kong

Overview and Introduction

In Hong Kong, the main objectives of the insolvency and bankruptcy law are to protect and maximise the value of the insolvent company and to collect and realise the assets of the bankrupt individual for the benefit of all creditors. Generally, the term "insolvency" applies to companies, whereas the term "bankruptcy" applies to individuals.

The bankruptcy legislation was substantially overhauled and culminated in what was perceived to be a more modern bankruptcy regime which came into operation on 1 April 1998. The legislation was further amended on 1 November 2016 to introduce new arrangements to encourage bankrupts to fulfil their obligations in respect of the administration of the estate.

The insolvency legislation was also recently amended on 13 February 2017 to increase protection offered to creditors against asset depletion primarily by including a new provision on transactions at an undervalue.

Applicable Legislation

The principal legislation governing insolvency and bankruptcy in Hong Kong consists of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32) ("**CWUMPO**"), the Companies (Winding Up) Rules (Cap 32H), the Bankruptcy Ordinance (Cap 6) and the Bankruptcy Rules (Cap 6A).

Personal Bankruptcy

Hong Kong's bankruptcy system is governed by the Bankruptcy Ordinance and the Bankruptcy Rules.

Jurisdiction of the Bankruptcy Court

A creditor may file a bankruptcy petition against a debtor if:

- The debtor is domiciled in Hong Kong;
- The debtor is personally present in Hong Kong on the day on which the petition is presented; or
- At any time within a period of three years ending with the day of the presentation of the petition, the debtor has been ordinarily resident or has had a place of residence in Hong Kong, or has carried on business in Hong Kong.

These provisions reflect the international commercial environment of Hong Kong and the high mobility of a large proportion of the working population.

Voluntary Arrangement and Interim Order

Voluntary arrangements are available to both bankrupts and non-bankrupts. The voluntary arrangement procedure allows the debtor to apply for an interim order, which provides the debtor with a "breathing space", i.e. a moratorium, for the debtor to reorganize his financial affairs and to come up with an arrangement that is acceptable to his creditors. During this "breathing space", no bankruptcy, enforcement or other proceedings can be brought or continued against the debtor without the leave of the court.

Bankruptcy Petition

There are two situations under which a creditor may present a bankruptcy petition against a debtor:

1. The creditor has served on the debtor a statutory demand and the debtor has not complied with the demand nor set it aside after the expiry of three weeks from the date the demand was served on the debtor; or

2. The execution of a judgment debt against the debtor by the petitioner has been returned unsatisfied in whole or in part.

The debtor may also present a petition for a bankruptcy order against himself on the payment of a deposit to the Official Receiver.

There are advantages that a debtor may enjoy by presenting a bankruptcy petition, including:

- If a bankruptcy order is made, the debtor gives up virtually all his property in return for being freed from the accumulated burdens of his debts and for being given a chance, in due course, to make a fresh start;

- The debtor avoids the inconvenience and dissipation of resources caused by multiple executions and other forms of enforcement process; and

- All the creditors are dealt with in the most equitable way through a collective process, whereby such assets as the debtor has for distribution among his creditors will be ratably shared by them in proportion to the debts that are owed.

Despite the advantages, the court has discretion to dismiss the debtor's petition. The court will do so if it is of the view that the petition is an abuse of the process.

Commencement of Bankruptcy

The bankruptcy of the person against whom a bankruptcy order has been made commences on the day on which the order is made.

Upon the making of the bankruptcy order, the Official Receiver is the trustee of the bankrupt and takes all steps to protect the bankrupt's estate.

In addition, all property belonging to or vested in the bankrupt at the commencement of the bankruptcy vests in the Official Receiver or if a person other than the Official Receiver is appointed as the trustee, such appointed trustee.

The bankrupt is under a duty to deliver up possession of any part of his estate that is in his possession or under his control to the Official Receiver or appointed trustee. In addition:

- Where property of the debtor includes things in action, such things shall be deemed to have been duly assigned to the trustee;

- A variety of persons, including bankers, lawyers and employers of a bankrupt who possess property of the bankrupt, must pay and deliver all such property to the trustee that they are not entitled to retain against the debtor; and

- The debtor must sign all necessary documents and instruments for selling any property outside Hong Kong for the benefit of creditors.

Discharge from Bankruptcy

A fundamental objective of the legislation is to enable bankrupts to make fresh starts after discharging their obligations under the bankruptcy laws.

The effect of a discharge is that the bankrupt is released from all bankruptcy debts, which include:

- Any debt or liability to which he is subject at the commencement of the bankruptcy; and

- Any debt or liability to which he may become subject after the commencement of the bankruptcy (including after his discharge from bankruptcy) by reason of any obligation incurred before the commencement of the bankruptcy.

It is noted, however, that the legislation provides that, as a condition of granting the discharge, the court may order the bankrupt to continue to make contributions to the estate in such amount and for such period as the court considers appropriate, up to a period of eight years from the date of the bankruptcy order.

There are two types of discharge under the bankruptcy regime:

- *Automatic discharge from bankruptcy*. The legislation provides for the bankrupt to be discharged automatically from bankruptcy after the expiry of four years for a first time bankrupt or five years for a repeat bankrupt, as measured from the date of commencement of the bankruptcy. However, the trustee in bankruptcy or a creditor of the bankrupt may apply to the court to object to the automatic discharge under certain grounds and therefore postpone the automatic discharge.

- *Early discharge from bankruptcy*. This permits the bankrupt to apply to the court for a discharge at any time before the expiry of the aforesaid period or, if he has been previously adjudged bankrupt, not less than three years after the date of the bankruptcy order.

These mechanisms for discharge were intended to give greater incentive to the bankrupt to cooperate with the trustee because a failure to cooperate could result in the trustee objecting to a bankrupt's discharge. In addition, if the bankrupt fails to cooperate, the automatic discharge may be suspended by order of the court.

Non-commencement Orders

The Bankruptcy (Amendment) Ordinance 2016 came into effect on 1 November 2016 and introduced a new requirement of an "initial interview" and consequently, the "non-commencement" order regime. An initial interview relates to the first meeting between the bankrupt and the bankruptcy trustee for the administration of the bankrupt's estate. The aim of this regime is to encourage bankrupts to fulfil their obligations at the "initial interview" with the bankruptcy trustee, in which the bankrupt is required to provide information about their affairs and estate in order to assist the bankruptcy trustee to administer the estate in an efficient manner.

If a bankrupt does not fulfil his obligations at the "initial interview" or fails to attend in person, the bankruptcy trustee may apply to Court for a non-commencement order within 6 months of the bankruptcy order. The non-commencement order stops time from accruing so the bankrupt cannot be automatically discharged from bankruptcy. The time will start to run again upon the actual date of compliance by the bankrupt.

The bankruptcy trustee can only apply for a non-commencement order for bankruptcy orders made on or after 1 November 2016.

Corporate Restructuring and Insolvency

Reorganizations, Restructurings and Work-Outs

There is no Chapter 11 or voluntary administration procedure in the CWUMPO in Hong Kong, so work-outs are essentially contractual arrangements that are mutually agreed between the debtor company and its financial creditors without any need to involve the court. The aim is to achieve the continuation of the company's business without the need to commence winding-up proceedings.

Terms of the Restructuring or Work-Out

The terms of the restructuring or workout arrangement are set by the parties involved through commercial negotiation and often involve reorganization of the company's business.

Success requires all creditors to agree on the terms of the restructuring to prevent any dissenting creditor from commencing winding-up proceedings or seeking to enforce any judgments already obtained.

Debt Rescheduling

Restructuring or work-outs often involve the rescheduling of debts, whether matured or otherwise, of the company facing financial difficulties. Often the company will seek to convince creditors not to demand or insist on full payment of debts. Besides deferring payment, part of the principal and/or part or all of the interest may be reduced, cancelled or waived after negotiation.

Multiple-Bank Restructurings

The restructuring of large corporations often involves multiple bank entities which often constitute the major creditors.

Generally, banks will be prepared to embark on a restructuring only if the prospect of eventual recovery is greater than it would be if the company was placed in liquidation. Cooperation and a recognition of shared interests are integral to a successful restructuring or work-out process.

The Hong Kong Monetary Authority and The Hong Kong Association of Banks have issued non-statutory guidelines on how member banks should deal with multiple-bank restructurings.

Corporate Insolvencies

In Hong Kong, there are three types of liquidation: members' voluntary liquidation, creditors' voluntary liquidation and compulsory liquidation.

Solvency is usually assessed on a cash-flow basis for going concerns, that is, the company can pay its debts as and when they fall due. However, after the liquidation process, solvency is assessed on an assets basis, i.e. realisable assets less known liabilities. If the result is positive, the liquidation will be solvent, the creditors will receive a complete recovery and there will be a return to shareholders. If it is negative, the liquidation is insolvent, and there will be a shortfall of assets, resulting in a shortfall to creditors and no return to shareholders.

Members' Voluntary Liquidation

This is available only where the company is solvent. The directors must swear a statutory declaration of solvency and creditors must be paid in full within 12 months. As the company is solvent, it is the members who control the conduct of the winding up.

Creditors' Voluntary Liquidation

A creditors' voluntary liquidation occurs where a company in its general meeting passes a special resolution to place the company into voluntary liquidation and where no statutory declaration of solvency has been sworn by the directors.

The resolution is usually passed on the basis that the company cannot by reason of its liabilities continue its business. As the company is not solvent, the creditors have control of the liquidation.

At the same time as summoning the shareholders' meeting, the company must give notice of a meeting of creditors via an advertisement in the Government Gazette and in one Chinese-language and one English-language newspaper in Hong Kong. The directors must also lay out a full statement

of the company's affairs as well as a list of creditors (with an estimated amount of their claims and securities held by them, if any) before the meeting.

At the creditors' meeting, the creditors nominate their liquidator or joint liquidators and may establish a committee of inspection of not less than three, and not more than seven persons. The role of the committee of inspection is both to assist and supervise the liquidator in the conduct of the liquidation.

The Court's Role in a Voluntary Liquidation

Both members' voluntary and creditors' voluntary liquidations are subject to the court's supervisory jurisdiction, which means that stakeholders such as the liquidator, creditors or shareholders may apply for the court's directions as to the conduct of certain aspects of the liquidation. But these liquidations can proceed with little or no guidance from the court, particularly where the liquidation is solvent. Voluntary liquidations can therefore provide an opportunity for a more managed liquidation process.

Compulsory Liquidation

A company may be wound up by the court on a number of grounds, most often in an insolvency situation because it is unable to pay its debts. There is also a broad discretionary power under which the court can order a company to be wound up where it is just and equitable to do so.

Application to the Court

The application submitted to the court to wind up a company may be made by a creditor, a shareholder or the company itself. This is done by way of a winding-up petition.

Once the petition is issued, the winding up of the company is deemed to have commenced. This is a key date to remember in the application of numerous legislative provisions relevant to the insolvency regime.

Uncontested Cases

In a straightforward, uncontested case, events usually proceed swiftly, concluding with a winding-up order against the company.

Complex Cases and Restructuring Attempts

In more complex cases, for instance, where there is a "White Knight" who attempts to rescue a company that is on the brink of insolvency, adjournments of the winding-up petition are often sought to enable the company to advance restructuring negotiations.

The Court's Supervisory Role

Throughout the administration of the compulsory winding up of a company, the court maintains a supervisory role. The court's approval is also required for certain matters, including the appointment of provisional liquidators and liquidators who act as officers of the court in the management of the company during the compulsory liquidation or restructuring process.

Powers of a Provisional Liquidator

When a winding-up petition has been presented to the court, the court may order the appointment of one or more provisional liquidators (either the Official Receiver or private insolvency practitioners) if the assets of the company are in danger or there has been an allegation that the personnel in control of the company have misappropriated the company's assets.

The purpose of appointing a provisional liquidator is to maintain the status quo of the company and preserve its assets and records. The order of the court appointing the provisional liquidator will specify the functions to be carried out in conjunction with the powers afforded to the provisional liquidator under the CWUMPO and the Companies (Winding Up) Rules.

Powers of the Directors Cease

There is Hong Kong case law that in the instance of a winding-up petition on just and equitable grounds, the appointment of a provisional liquidator operates to transfer to him the powers of the directors who thereby cease to be the company's authorised agents.[1] This means that, upon the appointment of the provisional liquidator, the managerial and operational powers of the directors in the company are vested in the provisional liquidator.

The directors retain a limited residual power (for example, to resist the winding-up petition) but it is not of a managerial nature. Decisions regarding the operation of the company are vested in the provisional liquidator from the time of his appointment, and the directors' powers are suspended at that time.

Priority of Claims

In insolvency proceedings, the assets available to the company are usually insufficient to satisfy all creditor claims. As a result, the priority or order of ranking of different claims is of utmost importance.

In court liquidations, claims that are not secured are distributed in a statutory prescribed order that, in brief, is as follows:

- Costs and expenses properly incurred in preserving, realizing or gathering the assets of the company, including the liquidator's remuneration and disbursements;
- Preferential creditors (e.g. certain debts due to employees or the government);
- Creditors secured by a floating charge;
- Ordinary unsecured creditors (including any shortfall arising from secured creditors after realization of their security); and
- Shareholders.

Secured creditors stand outside of the above priority of payments as they *are* entitled to look to the proceeds of their security.

Pari Passu Principle of Distribution

A general principle of *pari passu* distribution is applied; namely, ordinary creditors should rank equally amongst themselves.

Set-Off

Hong Kong has yet to enact legislation specifically applicable to set-offs in corporate insolvency. Notwithstanding this, set-off pursuant to the Bankruptcy Ordinance (section 35) applies where, before the company goes into liquidation, there have been mutual credits, mutual debts or other mutual dealings. The mutual dealings do not have to be in relation to the same transaction between the parties, although the mutual dealings must be between the same parties. In addition, mutual dealings are not restricted to debts incurred under contracts.

In such circumstances, an account is taken of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other. The effect of the existence of a set-off in a liquidation is that only the net balance owed will be paid to (or due from) the liquidator, and only one sum will be owed.

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1 Boldwin Construction Co. Ltd [2002] 1278 HKCU.

The purpose behind section 35 is to do justice between the parties. If there were no such thing as a set-off in insolvency, it would mean a creditor was bound to pay his debt to the company in full and at once, but in relation to the debt owed to him by the company, he would have to enter proof in the liquidation and would be entitled to receive only a dividend from the liquidator months or even years later. In other words, to the extent that a set-off is available, the creditor gets 100% on the relevant amount and is in a better position than unsecured creditors who are reliant on a *pari passu* distribution.

Clawback and Recovery Mechanisms

In all forms of liquidation, liquidators are empowered to investigate the affairs of a company and seek redress from the court where it considers assets belonging to the company have been dissipated. If an order is made by the court, the relevant directors, company officers or creditors may be required to repay or restore the property to the company, or contribute to the assets of the company, as the court considers appropriate. Below are some examples of possible offences that liquidators may investigate.

- *Unfair preference*. The liquidator may challenge creditors who have received payments from the company and may have been preferred against other creditors within six months of commencement of the liquidation. The six-month period is increased to two years in the case of "a person connected with the company", which is defined as:

  - an associate of the company; or

  - an associate of the company's director or shadow director;

  "Associate" is broadly defined to include:

  - in respect of individuals (eg, directors), a person is an associate of another person if that person is a spouse or cohabitant of that other person;

  - in respect of companies, a company is an associate of another company if the same person has control of both companies; and

  - a person can be considered as having control of a company if he is entitled to exercise, or control the exercise of, more than 30% of the voting power at any general meeting of the company or of another company which has control of it.

    Further, the company must be unable to pay its debts at the time of giving the preference or the company became unable to pay its debts as a result of giving the preference.

- *Transactions at an undervalue*. The liquidator can apply to court to invalidate a transaction at an undervalue within five years ending with the day on which the winding up of the company commenced. A transaction at an undervalue includes transactions which result in the company receiving a consideration which is significantly less than the value provided by the company. Similar to an unfair preference, the company must be unable to pay its debts at the time of the transaction or the company became unable to pay its debts as a result of the transaction.

- *Disposition of property with intent to defraud creditors*. This is voidable at the instance of the person prejudiced by the disposition, except if the property is disposed of for valuable consideration and in good faith to any person who has not received, at the time of the disposition, notice of the intent to defraud creditors.

- *Disposition after commencement of compulsory liquidation*. These dispositions or payments are void and the recipients of these funds or assets have to return the funds or assets to the liquidator, unless a validation order has been made by the court.

- *Fraudulent trading*. Where the business is carried on with intent to defraud creditors or for any other fraudulent purpose.

- *Misfeasance*. Where directors have breached their fiduciary duties to the company or have misapplied or retained property of the company for their personal benefit.

At present, there is no legislation in Hong Kong that prohibits insolvent trading or the incurring of a debt by a company at a time it is unable to pay its debts as they fall due.

Disclaimer of Onerous Contracts

Where a company has entered into unprofitable contracts or its assets include land burdened with an onerous covenant, shares or stock in companies, or unsalable property, the liquidator may, with leave of the court, surrender or disclaim that contract or property within 12 months after the commencement of liquidation. The disclaimer is binding on the rights and interests of the company and will release the company and the property of the company from liability as far as is necessary.

Court-Approved Arrangements and Reconstructions

The court also has jurisdiction to sanction a scheme of arrangement if a compromise or arrangement is proposed between a company and its creditors or any class of them, or between the company and its members (or any class of them) by the application of the company or any creditor or member of the company.

Absence of a Moratorium

One of the major problems with the CWUMPO is the absence of any formal moratorium available to the insolvent company. As a result, unless and until a scheme has been sanctioned by the court, which in a large corporate group structure may take many months, no member or creditor will be bound by the terms of the scheme and the insolvent company is not protected in any way from new litigation or enforcement procedures from creditors of the company.

In practice, the period between the presentation of a winding-up petition and the making of a winding-up order provides a moratorium period, otherwise not available under the current legislative regime, to conduct restructuring negotiations. The reason for this is the opportunity afforded to the company (and any creditor and person obligated to contribute to the assets of the company) to apply to the court for a stay of proceedings at any time after the presentation of a winding-up petition and before a winding-up order has been made.[2]

Requisite Elements for a Scheme to Succeed

The aim of a scheme of arrangement is always to achieve for the creditors a better pay-out than they would receive in a winding-up distribution. To succeed, the scheme must be approved by at least 75% in value and 50% in number of the creditors voting at the relevant scheme meetings, and must be sanctioned by the court. Once sanctioned, the scheme is binding on all creditors. For this reason, the support of the larger creditors to the scheme at an early stage is essential.

Creditors may choose to take a cut in the amount owed to them on the basis that they will receive some form of financial return and in some cases shares in the newly restructured company, which is considered to be better than receiving a minimal payment, if any, on a winding up of the company.

Out-of-Court Mechanisms

Receivers may be appointed by the court or in accordance with the terms of a debenture or charge. The power of a receiver will normally include the powers to collect, sell and manage the charged assets to protect the interests of the debenture holder. A receiver appointed out of court may apply to the court for directions in connection with the performance of his functions.

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2 Section 181 of the CWUMPO

Conclusions and Additional Observations

As mentioned at the outset, the insolvency and bankruptcy legislation in Hong Kong requires an in-depth review. Various parts of the legislation need to be updated and the various pieces of legislation need to be consolidated for easier handling.

Corporate Rescue Bill

The Hong Kong government is considering implementing a statutory corporate rescue procedure. The proposed legislation envisages a "provisional supervision" by an appointed third party, the provisional supervisor ─ similar to voluntary administration in the United Kingdom or Australia. The provisional supervision mechanism is intended to complement and enhance the existing restructuring arrangements in Hong Kong.

The provisional supervisor would take temporary control of the company, consider options for rescuing the company and if applicable, prepare a proposal for a voluntary arrangement which would bind the company, its officers, members, the provisional supervisor and all relevant creditors. It is also intended that the statutory corporate rescue procedure would involve predominantly out-of-court arrangements to save time and costs.

A significant feature of the proposed legislation is the introduction of a formal moratorium once the provisional supervision process commences. During the moratorium, no application for winding-up can be commenced or continued, receivers cannot be appointed and no proceedings or other process may be commenced or continued.

The aim of the statutory corporate rescue procedure is to provide an option for companies in short-term financial difficulties to initiate the procedure with a view to turning around and reviving its business instead of having to face a winding-up. This will also achieve a better return for the creditors of the company than in the case of a winding-up.

These proposed corporate rescue procedures are an important development for Hong Kong. Following the completion of a public consultation in 2009-2010 (the results of which were published in July 2010), the Hong Kong government is continuing to engage relevant stakeholders on specific issues with a view to preparing a bill. The proposed legislation will significantly improve the prospects of rescuing insolvent companies in Hong Kong.

Funding in Insolvency Proceedings

There are no specific provisions under the Hong Kong legislation for lending in insolvency proceedings. However, it is possible for a company to obtain financing from a willing lender when it is under insolvency proceedings pursuant to contractual arrangements. It is not uncommon for a liquidator to obtain financing from creditors to conduct investigations or litigation.

Recent case law also indicates that the CWUMPO enables a liquidator to sell or assign a cause of action to a litigation funder. However, this power of sale only applies to causes of action vested in the company, rather than the liquidator personally. It is expected that the litigation funding industry in Hong Kong will continue to grow.

Priority Ranking for Post-Liquidation Borrowing

Where a lender is willing to provide new money for the purpose of preserving and realising the assets of a company, such post-liquidation borrowing of the company may amount to an expense properly incurred by the liquidator that will rank in priority to any pre-liquidation debts.

In addition, although the general principle of *pari passu* distribution applies to unsecured creditors, the legislation provides that where a creditor has undertaken a substantial risk when giving the liquidator an indemnity for costs in litigation, the court may grant the creditor in question a greater share of the particular assets recovered than would normally be under the *pari passu* principle.

White Knight

A “White Knight” may also finance a company following a scheme of arrangement or restructuring of the company by acquiring or paying off part of the distressed debt.

In addition, during the restructuring process, banks and financial creditors will often agree to extend the credit lines of the company before the court sanctions the scheme so that the company may continue its restructuring attempts.

Impact of Credit Derivatives on Corporate Insolvencies

The development and growth of the credit derivatives market have had, and will continue to have, an increasing impact upon corporate insolvencies and restructurings.

As a result, when a restructuring is contemplated, debtors and their advisors are encouraged to consider the potential presence of credit derivative products (e.g. credit default swaps) and all their possible consequences. A potentially important practical issue may be whether a credit event has occurred at any point in the restructuring. The identity of those who may ultimately bear the credit risk of the debtor may also require investigation because the facts may be unclear on the face of the available documentation.

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