

February 2010

Provisional Supervision in Hong Kong – a New Dawn or Another False Start?

Pop Quiz – what does the US, UK, Australia, China, India, Singapore, Japan, most other moderately developed and many other developing countries have that Hong Kong doesn't. Well it's not an "Idol" talent show (although that possibly is also the case) and if you haven't picked it up from the title, it is a regime for corporate rehabilitation. But, having first proposed legislation as far back as 1996 and having had that legislation stall on a number of occasions, it is again back on the agenda in Hong Kong. To be known as Provisional Supervision ("PS"), the Financial Services and the Treasury Bureau ("FSTB") recently requested submissions on a further attempt at launching this surprisingly controversial but seemingly highly beneficial piece of legislation. In this article of FFA, we explore what PS might mean for stakeholders of financially distressed companies and the key issues still being considered before it becomes law (maybe).



In the US, Chapter 11 is the hallmark of Court driven restructuring. It is commonly used, is respected, deals with failures as large as Enron and GM and it works. The UK has Corporate Voluntary Arrangements, Australia has Voluntary Arrangements and even China has its still relatively new Bankruptcy Law. Whilst they all have their own idiosyncrasies, these legal regimes all allow corporate rehabilitation. That is, a mechanism that allows financially distressed companies some breathing space from their creditors whilst they seek to formulate a plan for survival rather than face extinction.

A number of times Hong Kong has contemplated an equivalent piece of legislation, broadly based on the UK and Australia creditor driven approach (control of the

company is placed in the hands of an independent party) rather than the US debtor driven approach (control of the company remains with the debtor) but the legislation has never passed through the Legislative Council ("LegCo") amidst a series of delays, lack of understanding and lack of commitment from Hong Kong's lawmakers.

The need for PS in Hong Kong

Hong Kong is one of the few, if not only, major financial centres in the world that does not have any proper form of corporate rehabilitation legislation (we do not consider Provisional Liquidation and Schemes of Arrangement legislation to be for the purpose of corporate rehabilitation). That in itself is a damning indictment on

February 2010

Hong Kong. Currently, China has far more progressive corporate rehabilitation legislation than Hong Kong by virtue of its relatively new Corporate Bankruptcy Law.

Many countries in Asia have corporate rehabilitation regimes. Following the Asian Financial Crisis of the late 1990s, many countries in Asia put in place or materially modified their insolvency and restructuring legislation. These include developing countries such as Indonesia, Thailand and the Philippines and more developed countries like South Korea and Taiwan. Asia's other major financial centres, Singapore and Japan, have had corporate rehabilitation legislation in place for some time. India, Asia's other powerhouse economy, also has recently modified its corporate rehabilitation legislation.

Change to insolvency and restructuring legislation is often the outcome of recession or difficult economic times. Whilst the global economy is improving and Asia has to a large extent avoided the calamitous economic conditions of Western countries, the need for corporate rehabilitation legislation in Hong Kong remains paramount. Paramount to saving businesses. Paramount to ensuring that Hong Kong has equivalent regimes to other major global financial centres. Paramount to ensuring that Hong Kong has equivalent legislation to China given the strong ties between the two and the number of financially distressed companies and groups that have exposure to both Hong Kong and China. And paramount to helping improve returns to creditors, in terms of both quantum and speed.

How it works

A company that is or is about to become insolvent can appoint an independent Provisional Supervisor ("Supervisor") to take control of the company. The Supervisor would essentially take all the powers of the directors and will be personally liable for debts incurred after their appointment but with an indemnity out of the assets of the company. At the same time, a moratorium would be put in place on creditors taking any legal actions against the company, whilst the Supervisor determines if a rescue plan, to be called a voluntary arrangement, can be put together to be voted on by creditors.

Secured creditors may be able to veto (terminate) the entire process, however, within 3 business days if they

Prominent Global Corporate Rehabilitation Cases

US

Legislation: Chapter 11

Cases: GM, Enron, CIT Group, Lehman Bros, WorldCom, Chrysler

UK

Legislation: Company Voluntary Arrangements

Cases: Collins & Aikman, JJB Sports, TXU, Powerhouse, Heath Lambert

China

Legislation: Enterprise Bankruptcy Law

Cases: Ferro China

Australia

Legislation: Voluntary Administration

Cases: Pasmenco, Sons of Gwalia, Ansett Airlines, Allco Finance, Opes Prime, ABC Learning

disagree with the appointment occurring. If this proposal remains, it would be a major point of differentiation to other similar regimes where secured creditors are typically either bound by the moratorium also (UK) or have a limited period of time to decide if they wish to enforce their security but not terminate the administration (Australia).

As a stick to prompt companies to enter into PS, the legislation includes insolvent trading provisions that seek to make a director liable for debts incurred after the director knew or should have known the company is insolvent i.e. if a director knows his company is insolvent, he should appoint a Supervisor to avoid personal liability for future debts incurred.

As indicated, the Supervisor will have a period of time (currently proposed to be 45 days) to submit some form of restructuring plan to creditors to vote on. That period will likely be able to be extended by either resolution of creditors or on application to Court, as is expected to be necessary in larger matters. The flowchart at the rear of this article shows the key steps.

The key issues to be determined

The FSTB has sought submissions on a number of key points in the proposed legislation. These include:

- How PS can be initiated – the legislation currently contemplates that PS may be initiated by a company's directors, liquidator or provisional liquidator. What is not clear is whether the liquidator/provisional liquidator can appoint themselves as Supervisor. If not, would they really appoint someone else? In other jurisdictions, a major secured creditor can also make such appointments. Should creditors have the ability to apply to Court for the appointment of the Supervisor instead of seeking a provisional liquidator (but bearing in mind a provisional liquidator can appoint a Supervisor) given many such appointments are currently being used to seek a restructuring anyway and PS will be a more effective regime to pursue a restructuring. These are all issues being considered that will have an important impact on the use of the PS process.
- What protection should employee entitlements have – suggestions range from requiring cash to meet entitlements upfront to simply requiring the rescue plan to protect entitlements. One of the more comment provoking elements of the legislation and key reasons for its delay, has seen employee groups argue strongly to protect employees. Equivalent legislation in other countries typically requires entitlements to be protected under the rescue plan. Requiring cash to be paid upfront (for entitlements that are not even "due and payable", but accrued) by a financially distressed company where its directors face penalties for trading whilst insolvent doesn't sound like it will help save companies (or jobs!). And pity the Supervisor that needs to face thousands of employees of the China incorporated subsidiary that won't be in PS to explain that the head office employees in Hong Kong that caused the problems in the first place have their entitlements protected but there is no more cash for employees in China. Hopefully common sense prevails and employee entitlements are not required to be met upfront, which in our view risks undermining the intention of the legislation.
- Who can be appointed Supervisor – suggestions include that all CPAs, solicitors and even specialists with experience in other countries can take the appointment. Whilst obviously a point of self interest for us, it does seem strange that a far wider group of potential appointees is being considered than can currently become a liquidator in Hong Kong for a role that we consider to be a more difficult and specialised job given the role will require management of an operating business and imposition of personal liability for debt incurred whilst seeking to restructure the company. Who would monitor and supervise such a wide range of appointees is a further issue, compared to liquidators who are subject to the supervision of the Official Receiver?
- What protection should secured creditors have – as noted earlier, the legislation currently contemplates allowing major secured creditors a veto right to terminate the process. Whilst the rights of secured creditors must be protected, a veto right will simply promote receivership and liquidation rather than promote saving businesses given the insolvent trading provisions will force some form of formal outcome. The outcome on this issue will be critical for secured creditors. Amendment to the current proposed (only) 3 day veto right decision is warranted. Otherwise, expect to see a number of companies kicked out of PS simply because the secured creditor didn't have time to consider the issues or complaining that they didn't get the notice until day 4 and can't do anything about it.
- How strong should the insolvent trading laws be – directors beware! Having personal liability for incurring debt when a company is insolvent will be a dramatic change to Hong Kong's corporate landscape, as seen in other countries that have introduced such laws. Don't underestimate how big an issue this will become over time. There will be insolvent trading provisions brought in, the issue is just how strong will they be. The days of silent and non attentive directors will need to change. Expect to see a lot more BVI companies acting as directors (public companies however are not permitted to have corporate directors).



bringing unique focus to
industry and business issues

ferriers focus asia

February 2010

What's next?

The FSTB has indicated that it will consider the submissions made to it regarding the proposed legislation with the aim of reaching conclusions by mid-2010, with a view to introducing the legislation to LegCo "in 2010-11".

Given the history of the legislation, it would be brave to be confident about it becoming law. But it should, and one day must. Most other countries have something like it. Hong Kong certainly needs it. The reasons for earlier delays are not good ones.

If it does come into being, PS will be the biggest change in the corporate restructuring space that Hong Kong has ever seen. Having been at the forefront of the introduction of Australia's corporate rehabilitation legislation back in 1993, Ferrier Hodgson understands the changes and impacts the PS legislation will have to stakeholders of Hong Kong companies. The imposition of personal liability on directors for insolvent trading, the decisions to be made in short periods of time by secured lenders, the tight timeframes for Supervisors and creditors to make decisions and the need to quickly devise restructuring proposals will be a landmark change to corporate recovery culture in Hong Kong. But one which is long overdue.

For more information about our Asian businesses, please contact:

Hong Kong: Rod Sutton
+852 2820 5600
rsutton@fh.com.hk

China: Mark Chadwick
+86 21 6141 5300
markchadwick@ferrierhodgson.com.cn

Indonesia: Rob Jolly
+62 21 521 1658
robjolly@ferrierhodgson.co.id

Japan: Kentaro Mochizuki
+813 3560 8301
kmochizuki@fh-tokyo.jp

Malaysia: Andrew Heng
+60 3 2273 6227
aheng@fhmh.com.my

Philippines: Anthony Quach
+63 2 864 0991
aquach@ferrierhodgson.com.ph

Singapore: Tim Reid
+65 6414 1400
tim.reid@fh.com.sg

Our other offices include:

Sydney: Peter Walker
+612 9286 9808
peter.walker@fh.com.au

Melbourne: Peter McCluskey
+613 9600 4922
peter.mcccluskey@fh.com.au

Adelaide: Bruce Carter
+618 8100 7600
bjcarter@sa.fh.com.au

Brisbane: Greg Moloney
+617 3831 4833
gmoloney@qld.fh.com.au

Perth: Andrew Saker
+618 9214 1444
asaker@perth.fh.com.au

Or find out more at:
www.ferrierhodgson.com



Nick Gronow
Executive Director
Ph: + 852 2820 5667
Email: ngronow@fh.com.hk

[Related newsletters and articles](#) >

If you have any questions or comments about Ferriers Focus Asia please email [Ferrier Hodgson](mailto:ferrierhodgson@ferrierhodgson.com)

RESTRUCTURE & TURNAROUND

CORPORATE ADVISORY

RISK SOLUTIONS

CORPORATE RECOVERY

[Subscribe](#) > [Unsubscribe](#) > [Disclaimer](#) > © Ferrier Hodgson 2010



FERRIER HODGSON

OVERVIEW OF PROVISIONAL SUPERVISION

OBJECTIVE: SAVE COMPANIES, GREATER REALISATIONS, IMPROVE RETURNS

