

Restructuring and insolvency in Hong Kong: overview

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FORMS OF SECURITY

1. What are the most common forms of security granted over immovable and movable property? What formalities must the security documents, the secured creditor or the debtor comply with? What is the effect of non-compliance with these formalities?

Immovable property

Common forms of security. The most common forms of security are as follows:

- **Legal mortgage.** A legal mortgage is created by way of a legal charge that must be in writing and executed as a deed expressed to be a legal charge. A legal mortgage creates powers and protections, including foreclosure and the equity of redemption. The legal mortgagee cannot take possession before default by the mortgagor.
- **Equitable mortgage.** An equitable mortgage can be created by deed, or simply by depositing title deeds or other similar documents with the mortgagee. An equitable mortgage does not transfer legal title to the mortgagee and the mortgagee has no power to sell the land on the mortgagor's default. An equitable mortgage can arise if the parties intended to execute a legal mortgage but failed to comply with the requisite formalities.
- **Fixed charge.** A fixed charge does not affect ownership of the charged property, nor its possession. It simply provides the chargee with a right to proceeds of the asset on the chargor's default.

Formalities. The following formalities apply:

- **Deed.** Legal charges over land and buildings must be created by deed and expressed to be a legal charge. In the absence of a valid deed, the charge or mortgage can still take effect as an equitable charge or mortgage.
- **Land Registry.** In order to protect priority, charges over land and buildings must be registered with the Land Registry. Priority will be given effect from the date of:
 - execution of the deed if registered within one month of the date of execution; or
 - registration of the deed if registered more than one month after the date of execution.
- **Companies Registry.** A company incorporated in Hong Kong or registered in Hong Kong as a non-Hong Kong company must register mortgages over any land it owns with the Companies Registry within one month after the date of creation of the mortgage. However, where the mortgage is created outside Hong Kong over property situated outside Hong Kong, the mortgage must be registered one month after the date on which a certified copy of the instrument (if despatched with due

diligence) could have been received in Hong Kong. Charges must also be registered. The registration requirements do not apply to foreign companies that are not registered in Hong Kong, regardless of whether or not they have a place of business in Hong Kong.

Effects of non-compliance. If a charge is not registered at the Land Registry, it will be ineffective against a bona fide purchaser or mortgagee for valuable consideration. Failure to register the charge will not affect the validity of the charge itself as between the parties to the security.

If a registrable charge is not registered at the Companies Registry, it will be ineffective against the liquidator and creditors of the chargor company. Failure to register the charge will not affect the validity of the charge itself, or the obligation to repay the money secured by the charge.

Movable property

Common forms of security. The most common forms of security are as follows:

- **Mortgage.** A legal or equitable mortgage can be created over movable property (*see above*).
- **Fixed charge.** A fixed charge provides the charge holder with a right to the proceeds of the asset on the chargor's default. A fixed charge is created over a particular asset. Once a fixed charge is granted, the chargor can only deal with and dispose of the asset with the chargee's consent. If the chargee allows the chargor to deal with the asset in the ordinary course of business, the court can treat the charge as floating rather than fixed (*see below*).
- **Floating charge.** In contrast with a fixed charge, floating charges do not attach to one particular asset, but are created over a class of assets (present and future); the chargor can continue to deal with the assets in the ordinary course of business until the charge crystallises and steps are taken to enforce it by the chargee. On crystallisation, a floating charge is converted into a fixed charge that attaches to the charged assets.
- **Pledge.** A pledge is a form of security whereby possession of the asset is transferred to the pledgee. The pledgee holds the asset until the debt is settled, although legal title will remain with the pledgor. On default by the pledgor, the pledgee can sell the pledged asset to recover the debt.
- **Lien.** A lien is a form of security whereby possession of the asset is transferred to a creditor by a debtor until the underlying obligations are discharged. By contrast with a pledge, a lien holder has no right to sell the relevant assets. A lien will terminate when the asset is returned to the legal title holder.
- **Security over personal chattels.** It is possible for a creditor to take a written mortgage over personal chattels to secure a loan (but this is uncommon). Where the instrument confers a right on the creditor to seize the chattel in the event of default, the mortgage may be considered a bill of sale. Subject to certain

conditions and exceptions, such security is required to be in a particular statutory form and must be duly attested and registered with the Registrar of the High Court, or the security interest will be void to the extent of those personal chattels.

Formalities. The formalities required for movable property will depend on the form of security. Registration may be required. In general, charges must be registered with the Companies Registry within one month of creation if the charge is over the assets of a Hong Kong incorporated company or a company registered in Hong Kong as a non-Hong Kong company. A longer period applies if the document was executed overseas and secures assets that are located overseas.

Certain classes of assets have separate registries and registration will be required or desirable at the relevant registry. For example, a mortgage over a Hong Kong registered ship must be in a prescribed form and registered with the Hong Kong Shipping Registry. Priority for ship mortgages is taken from the date of registration, and not the date of creation. Similarly, notice of mortgages or charges over aircraft is usually given to the Civil Aviation Department in Hong Kong, but this is not a formal requirement. Public registers also exist in respect of certain types of intellectual property and security interests over such assets should be registered on those registers by the requisite deadline or priority of the security interest may be impacted. If the chargee is a Hong Kong incorporated company or a company registered in Hong Kong as a non-Hong Kong company, the charge must be registered with the Companies Registry in the manner outlined above.

Effects of non-compliance. Failure to register a registrable charge at the Companies Registry will result in the charge being ineffective against any liquidator and creditor of the company and, in certain circumstances as required by the Bills of Sale Ordinance (Cap. 20), failure to register a security interest over personal chattels can result in that security interest being void.

CREDITOR AND CONTRIBUTORY RANKING

2. Where do creditors and contributories rank on a debtor's insolvency?

In Hong Kong, the most common procedure for a debtor's insolvency is liquidation. In a corporate liquidation, creditors and contributories usually rank as follows:

- **Secured creditors.** Secured creditors are generally entitled to pay themselves from their security. They are then entitled to claim as an unsecured creditor for any balance that remains unpaid after realisation of the security. The expenses of the receiver incurred in realising the secured assets can be deducted from the proceeds of the assets. Where there is more than one form of security over the same asset, a legal mortgage will generally rank ahead of an equitable mortgage, and fixed charges will rank in order of date of creation.
- **Costs, charges and expenses properly incurred in the liquidation.** The liquidators are entitled to their remuneration first, followed by the costs of the winding up. Where assets are disposed of in the liquidation, stamp duty can be chargeable and must be included as an expense properly incurred in the winding up.
- **Preferential creditors.** Employee claims rank first in this category, and can include claims for wages and salaries, severance payments, long service payments, amounts due in respect of employee compensation and claims for holiday pay. Government and statutory debts (such as rates and taxes) and where applicable, claims by bank deposit holders or claimants under contracts of insurance can also be included as preferential creditors' claims.
- **Floating charge holders.** Where a floating charge has crystallised or a receiver is appointed under the instrument by

which the charge was created, floating charge holders can be paid from the proceeds of sale of the assets, but only if the claims of all preferential creditors have been satisfied. Charge holders will be entitled to claim as an unsecured creditor for any balance that remains unpaid after realisation of the security. Any floating charges created over the same assets will rank in order of date of creation.

- **Ordinary unsecured creditors.** All remaining unsecured creditors will share the remaining surplus. If there are insufficient assets to meet the claims of ordinary unsecured creditors they will receive a share pro rata to their respective claims.
- **Shareholders.** Any remaining balance is distributed to shareholders. The articles of association of the company can specify an order of priority.

Separately, and depending on the circumstances of the case, it may be open to creditors to recover their "own" assets in the debtor's possession, for example if subject to valid retention of title clauses (see *Question 3*) or held on trust by the debtor.

UNPAID DEBTS AND RECOVERY

3. Can trade creditors use any mechanisms to secure unpaid debts? Are there any legal or practical limits on the operation of these mechanisms?

A reservation of title clause (*Romalpa* clause) is often included by trade creditors in their contracts. The clauses are designed to provide that goods supplied will not become the property of the buyer unless and until full payment has been made. Not all *Romalpa* clauses will be effective on insolvency; it will depend on the words used and the circumstances of the trade.

Where drafted to secure the proceeds of sale of the goods, a *Romalpa* clause can create a floating charge which, unless registered, will be void on the buyer's insolvency. A simple *Romalpa* clause would not generally require registration as a security interest provided that title to the goods that are subject to the *Romalpa* clause has not passed to the buyer. *Romalpa* clauses will also be ineffective against a *bona fide* third party purchaser of the goods for value and without notice of the clause.

In relation to the sale of goods, where property in goods has not yet passed to the buyer, an unpaid seller has the following statutory rights in relation to the goods:

- Lien on the goods, or a right to retain them for the price (while in possession of them).
- Right to stop the goods in transit after parting with possession of them (on the insolvency of the buyer).
- Right of resale (in certain situations).

4. Can creditors invoke any procedures (other than the formal rescue or insolvency procedures described in *Question 6* and *Question 7* to recover their debt? Is there a mandatory set-off of mutual debts on insolvency?

Debt recovery procedures

Creditors can commence legal proceedings to recover their debt as an alternative to insolvency procedures. Under certain circumstances, interim remedies can be obtained to preserve assets during the course of the legal proceedings. For example, the court can grant a *Mareva* injunction that operates to prevent a debtor from dealing with his/her assets pending resolution of the dispute. To obtain a *Mareva* injunction, a creditor must show that he/she has a good arguable case on a substantive claim and that there is a real risk of dissipation of assets, or removal of assets from Hong Kong

that would render the judgment of no effect. It is not used often, but the court has a discretionary power to appoint a receiver in aid of a *Mareva* injunction.

The court also has the power to appoint a receiver in debt recovery actions. This will not be granted unless the court is convinced of its necessity. The powers of a court appointed receiver are defined by the terms of the order appointing them. Their duties are to collect the property over which they have been appointed and pay money received into court, or as the court directs. The receiver has a fiduciary duty to protect, collect and realise assets and property and to pass the assets or property to beneficiaries or creditors.

In many cases the security documentation can provide for the appointment of a receiver to take possession of specific assets on a debtor's default. If the receiver is appointed under a floating charge, the appointment will usually take place on crystallisation of the charge. Court approval is not required to appoint a receiver in this manner, however such appointments can be open to challenge (usually by challenging the validity of the underlying security). Where assets are realised under a floating charge, the receiver must account to any preferential creditors before paying the debt owed to the charge holder (see *Question 2*).

Mandatory set-off of mutual debts in insolvency

There must be mutuality for a set-off of debts to apply in insolvency:

- Mutual credits.
- Mutual debts.
- Other mutual dealings between mutual parties.

This does not mean that the debts must have arisen out of the same transaction or contract, but there must be mutual debts or other liabilities that ultimately allow for an account to be taken. If an individual has been acting in different capacities across transactions, there will be no mutuality and no set-off will apply. For example, there will be no mutuality and no set-off where debts are due from a trustee or partner, but other sums are owed to them in their individual personal capacities.

For a creditor to take advantage of any set-off, the mutual claims must have existed on the date the company is wound up, because this is the relevant date to conduct the mutual account. If there is a contingent claim, it can be set-off provided that the obligation existed at the commencement of the winding up.

The set-off provisions are mandatory with few exceptions. If a creditor has both ordinary and preferential claims, the set-off must be conducted proportionately with respect to each category of claim. Similarly, if a creditor has both secured and unsecured claims, the creditor must elect to either:

- Surrender his/her security and prove in the liquidation.
- Set-off only against the unsecured claims.

STATE SUPPORT

5. Is state support for distressed businesses available?

The Trade and Industry Department of the HKSAR Government provides support to small and medium enterprises (SMEs) in Hong Kong. As of June 2020, there were approximately 340,000 SMEs in Hong Kong.

The Trade and Industry Department (through its Support and Consultation Centre for SMEs) provides free business information and advisory services, and administers SME funding schemes. The Department also operates an SME Loan Guarantee Scheme to assist SMEs to secure loans of up to 50% of the approved loan (up to a maximum of HKD6 million) to acquire business installations and equipment, or to meet working capital needs.

The Hong Kong Association of Banks and the Hong Kong Monetary Authority have issued formal but non-binding and non-statutory guidelines addressing how institutions should deal with corporate customers where the borrower is dealing with multiple banks. The guidelines emphasise that it is in the interests of all stakeholders that a business must survive if there is a reasonable possibility that it is viable. Under the guidelines, lenders are encouraged to opt first for a workout (see *Question 6*) and not to withdraw facilities or hastily put the borrower into receivership or issue legal proceedings demanding repayment.

2019 novel coronavirus disease (COVID-19). The Hong Kong Government has not introduced any formal relief measures into Hong Kong's corporate insolvency legislation in response to the global COVID-19 pandemic, unlike several other jurisdictions in the region. However, the Hong Kong Official Receiver's Office has issued certain guidance to insolvency practitioners in respect of administering personal bankruptcy and corporate liquidation cases during COVID-19. This has included encouraging bankruptcy trustees to use their personal judgment in administering personal bankruptcy cases with as much flexibility as possible.

Since early 2020, the Hong Kong Government has also initiated various measures to provide financial assistance to individuals and businesses affected by COVID-19.

RESCUE AND INSOLVENCY PROCEDURES

6. What are the main rescue/reorganisation procedures in your jurisdiction?

Workout

Objective. A workout is an agreement made outside of court between the company and its major creditors for the rescheduling of the company's debts. Insolvency is not required.

Initiation. A workout can be initiated at any time either by the company or its creditors. A restructuring plan is usually recommended by a committee chaired by a lead creditor or bank. The court is not involved, and the process is entirely voluntary.

Substantive tests. There are no relevant substantive tests.

Consent and approvals. A workout is negotiated between the company and its creditors. Contractual and security rights may only be varied with the consent of the relevant threshold of creditors or secured creditors under the company's existing contractual documentation. Depending upon the terms of the proposed restructuring, shareholder consent may also be required to implement the workout.

Supervision and control. The company's management is not required to change during an informal workout. Once a workout is agreed, the company will operate under the terms of its arrangement, which can include, for example:

- A committee of creditors being formed to monitor implementation.
- The appointment of board observers or nominees.
- Cash management arrangements.

Protection from creditors. A workout provides no legal protection from creditors. There is no moratorium and creditors can commence liquidation proceedings if they did not agree to the workout. However, in practice informal standstill agreements between creditors may be agreed.

Length of procedure. There is no required timeframe for a workout. The process can take months or years.

Conclusion. The company will continue to exist and be managed as normal, subject to the terms of the workout arrangement. There is no moratorium on debts, so it is possible for an unsatisfied creditor

to commence insolvency proceedings at any time, subject to any agreed standstill or forbearance arrangements.

Scheme of Arrangement

Objective. A scheme of arrangement is a statutory, binding compromise reached between a company and its shareholders or creditors. Insolvency is not required, and a scheme of arrangement can be used in other scenarios, for example, for the reduction of share capital. A scheme of arrangement must be approved by the court.

Initiation. A scheme of arrangement can be initiated at any time and is typically initiated by the company itself (or its provisional liquidators or liquidators if appointed). The procedure is voluntary. A scheme of arrangement can be made in relation to a Hong Kong incorporated company or, in certain circumstances, a foreign company.

Substantive tests. There are no relevant substantive tests. Insolvency is not required. Schemes of arrangement are often used in reorganisations and mergers.

Consent and approvals. In general, a scheme of arrangement must be approved by all classes of creditors or shareholders (as applicable). The court will review the plan before sanctioning the convening of the separate meetings of the creditors or shareholders (as applicable). The scheme must be approved by at least 75% in value and more than 50% in number of the classes of creditors or shareholders voting. The scheme must also be approved by the court. A copy of the court order sanctioning the scheme must be registered with the Companies Registry. The scheme of arrangement can be used to compromise the claims of both secured and unsecured creditors provided the requisite majority in each class have voted in favour of the scheme. Depending on the terms of the scheme, shareholder consent may also be required to implement the scheme.

Supervision and control. Once a scheme of arrangement is sanctioned by the court, unless a liquidator or provisional liquidator has been appointed, the company's management can remain in place. A scheme administrator may be appointed to implement the scheme of arrangement once it becomes effective. The company will ordinarily appoint legal and financial advisors to formulate and negotiate the terms of the scheme, prepare the scheme documentation and make the relevant applications to the court.

Protection from creditors. Initiation of a scheme of arrangement does not trigger a moratorium on creditor actions. However, a successful application to court for the sanction of a scheme of arrangement will lead to a moratorium on creditor actions against the company if the terms of the scheme provide for such a moratorium. During the formulation and negotiation of a scheme, a company may also seek to enter into a contractual standstill arrangement with its creditors to prevent creditor enforcement during that time.

Length of procedure. There is no prescribed timeframe for a scheme of arrangement, but the process generally takes three to six months.

Conclusion. Hong Kong does not currently have any formal corporate rescue procedures. A scheme of arrangement will conclude when its terms have been implemented. A court-sanctioned scheme of arrangement is the only procedure that can protect a company if the management want to preserve the company as a going concern.

Members' voluntary liquidation

Objective. The purpose of a members' voluntary liquidation is to wind up a company in situations where the company is solvent but the shareholders no longer wish it to continue trading. The company's creditors will be paid in full on winding up, and any remaining surplus funds will be distributed to the shareholders.

Initiation. A members' voluntary liquidation is only possible where the directors sign a certificate of solvency to the effect that the

company will be able to pay its debts in full within a specified period not exceeding 12 months from the commencement of the winding up.

Substantive tests. The company must be able to pay in full all creditors within 12 months from the commencement of the winding up (even if the liquidation process takes longer than 12 months). If the liquidator believes that the company will not be able to pay its debts in full during the relevant period, the liquidator will convene a meeting of creditors and present a statement of the assets and liabilities of the company.

Consent and approvals. A declaration of solvency must be made by the directors to the effect that they have made a full inquiry into the affairs of the company, and they have formed the opinion that the company will be able to pay its debts in full within a specified period, not exceeding 12 months from the commencement of the winding up. The shareholders will appoint the liquidator and fix the liquidator's remuneration. The appointment is formalised by the members passing a resolution at a general meeting (during which the resolution to wind the company up is also passed).

Supervision and control. The directors' powers in relation to the company cease on the appointment of the liquidator, except where the company in general meeting or the liquidator agrees that they can continue.

Protection from creditors. There is no moratorium on debts in a voluntary winding up.

Length of procedure. Creditors must be paid in full within 12 months. The winding up itself can take longer.

Conclusion. Once all creditors are provided for or paid in full, the liquidator will wind up the company. Dissolution brings the company to an end.

7. What are the main insolvency procedures in your jurisdiction?

Creditors' voluntary liquidation

Objective. If a company is insolvent and there is no way of avoiding liquidation, the directors and shareholders can (in the absence of a creditor petitioning the court) place the company into creditors' voluntary liquidation.

Initiation. The shareholders of a company can initiate a creditors' voluntary liquidation by passing a special resolution (that is, at least 75%) to voluntarily wind up the company and a meeting of creditors must be held not later than 14 days from the meeting at which that voluntary winding-up resolution was proposed. Notice of the creditors' meeting must be sent by post to the creditors and advertised at least seven days before the day of the meeting. A statement of affairs of the company must be provided before the relevant meeting of creditors and any nomination of a liquidator by the meeting of creditors will prevail over any contrary nomination by the shareholders.

Alternatively, in limited circumstances the directors (or the majority of the directors, if there are more than two) can initiate a creditors' voluntary liquidation if they have formed the opinion that the company cannot continue its business because of its liabilities, and that it is not reasonably practicable to commence it in any other way. The procedure is initiated by the directors by:

- Passing a resolution which (among other things) confirms that the directors consider:
 - it necessary that the company be wound up; and
 - that the winding up should be commenced under such procedure because it is not reasonably practicable to commence it in any other way.

- Calling a meeting between the company and its creditors.
- Appointing a provisional liquidator with effect from the commencement of the winding up.
- Delivering a winding-up statement to the Registrar of Companies. Misuse of this procedure carries a penalty, including a fine and imprisonment.

Substantive tests. *See above.*

Consent and approvals. The procedural requirements of conducting a creditors' voluntary liquidation are generally the same as for a members' voluntary liquidation (*see Question 6*). However, a key difference is that creditors can appoint a committee of inspection whose agreement is needed before the liquidator can take certain actions.

Supervision and control. The directors' powers in relation to the company cease on the appointment of the liquidator, except where the committee of inspection, if there is one, or otherwise the creditors, agree that they can continue.

Protection from creditors. There is no moratorium on proceedings against the company. However, the court has discretion to stay legal proceedings on the application of a creditor, contributory or the liquidator.

Length of procedure. A liquidator can be appointed within one month under normal circumstances. However, if the alternative procedure is used (*see above*) the appointment may be faster.

Conclusion. The liquidator must realise as many of the company's assets as possible for distribution to creditors. The liquidator will then wind up the company, and dissolution brings the company to an end.

Compulsory liquidation

Objective. The purpose of a compulsory liquidation is to liquidate a company's assets, consider claims and distribute the proceeds of the liquidation to creditors in order of priority.

Initiation. A compulsory liquidation is commenced by presentation of a winding up petition to the court. The petition can be presented by various parties (including creditors and the company itself). In practice, most compulsory liquidation petitions are presented by unpaid creditors. The party presenting the petition must satisfy certain notice, filing and advertising requirements. In the case of a petition presented by a creditor, a statutory demand is usually served first providing a 21-day window for the debtor to pay the debt.

Substantive tests. There are a number of grounds upon which the court can wind up a company. The most common grounds are that the:

- Company has by special resolution (that is, at least 75%) resolved that it must be wound up.
- Company is unable to pay its debts. Failure to pay a statutory demand within 21 days is an act of presumed insolvency, as is failure to satisfy a judgment debt in whole or in part.
- Court considers that it is just and equitable that the company be wound up.

The court will not make a winding up order if the company establishes that there is a genuine dispute on substantial grounds regarding the debt that is the subject of the petition.

Consent and approvals. Following the presentation of the petition, the court can appoint a provisional liquidator to maintain the status quo and safeguard the assets of the company pending the making of the winding up order. The company, a creditor or contributory can apply to the court for the appointment of a provisional liquidator if:

- There is a good prima facie case that a winding-up order would be made.

- It is appropriate in all the circumstances for a provisional liquidator to be appointed, such as in the case of risk of jeopardy to or dissipation of the company's assets.
- On the appointment of a provisional liquidator there is a stay on the commencement or continuation of actions or proceedings against the company without leave of the court, and the provisional liquidator will assume control of the company's affairs from the company's directors.

A liquidator will be subsequently appointed (often at the first creditors' meeting).

After a winding up order has been made, the following steps are taken:

- A statement of affairs of the company is delivered.
- A meeting of creditors and contributories is called.
- A committee of inspection can be appointed.
- Creditors file proofs of debt to claim in the liquidation that the liquidator will consider on their merits. Creditors can appeal against the liquidator's rejection of their claim.
- The liquidator presents a report on the reasons why the company failed and the affairs of the company to the court.
- Investigations are taken into any potential wrongful actions taken by the directors of the company and any pre-liquidation transactions that could potentially be set aside (*see Question 10*).

Supervision and control. Unless a provisional liquidator is appointed, the company's existing board and management will remain in control of the company until a winding up order is made, upon which the powers of the existing directors will cease and the liquidator (or the official receiver in Hong Kong) will take control of the company's affairs under the supervision of the court. A creditors' committee (the committee of inspection) is appointed to supervise the liquidator in relation to certain matters. In particular, the court or the committee of inspection must approve compromises with creditors and the commencement of litigation.

There is an alternative summary winding up procedure that can be used if the assets of the company are unlikely to exceed HKD200,000.

Protection from creditors. At any time after the presentation of the winding up petition and before the winding up order is made, the company or any creditor or contributory may apply to the court for a stay of proceedings. When a winding up order is made, there is an automatic stay on all actions and proceedings against the company. In certain circumstances, proceedings can continue with the leave of the court.

Length of procedure. It usually takes several months to obtain a winding up order. Depending on the scale of the liquidation, the liquidation process itself can take several years to conclude.

Conclusion. The liquidator will apply to the court for release when the liquidation is complete and the assets have been realised and distributed. Dissolution then brings the company to an end.

STAKEHOLDERS' ROLES

8. Which stakeholders have the most significant role in the outcome of a restructuring or insolvency procedure? Can stakeholders or commercial/policy issues influence the outcome of the procedure?

Creditors have significant influence in insolvency procedures in Hong Kong. A dissenting creditor can sue the company, seize the company's assets or present a winding up petition. In addition, the consent of creditors is required unanimously in a workout, and by

majority in number and at least 75% by value of the claims of scheme creditors present and voting in the case of a scheme of arrangement (see *Question 11*).

In a compulsory liquidation, one particular stakeholder (usually a creditor) can exercise significant informal influence by presenting the winding up petition to the court. This allows the stakeholder to have an impact on the procedural timetable and often some practical influence on the appointment of the liquidator.

LIABILITY

9. Can a director, partner, parent entity (domestic or foreign) or other party be held liable for an insolvent debtor's debts?

Director

A director will be personally liable for the debts of an insolvent company if they have provided a personal guarantee. A director or shadow director can also be held liable for a breach of fiduciary duty and can be ordered to repay to the company amounts wrongfully transferred, or to compensate the company for its losses by way of damages or equitable compensation.

See *Question 14* in relation to proposed reforms on insolvent trading.

Partner

The insolvency of partnerships (other than limited partnerships) is governed by the Partnership Ordinance (Cap. 38) which provides that every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he or she is a partner.

Parent entity (domestic or foreign)

A parent company is a separate legal entity and, unless it has provided a guarantee or has been involved in fraudulent conduct, will generally not be liable for the debts of an insolvent subsidiary.

Other party

If during the course of the winding up it becomes apparent to the court that any business has been carried out with an intent to defraud creditors or for a fraudulent purpose, the court can hold any person who was knowingly a party to the fraudulent conduct personally liable, without any limitation of liability. In addition, fraudulent trading is a criminal offence, with a penalty of a fine and imprisonment. A director can also be disqualified on grounds of unfitness, irrespective of any subsequent criminal proceedings. Actions for fraudulent trading in Hong Kong are rare, due to the difficulty in establishing an intention to defraud.

SETTING ASIDE TRANSACTIONS

10. Can an insolvent debtor's pre-insolvency transactions be set aside? If so, who can challenge these transactions, when and in what circumstances? Are third parties' rights affected?

In relation to a compulsory liquidation, any dispositions of property or transfers of shares made after the commencement of the liquidation will be void. There are also a number of pre-insolvency transactions that can be challenged or set aside by the liquidator, including:

- **Transactions at an undervalue.** The company enters into a transaction with a person at an undervalue if (for that transaction) the company receives:
 - no consideration; or
 - consideration which is significantly less than the consideration provided by the company.

- For the transaction to be set aside, it must have been entered into in the five-year period before the company's winding up is commenced at a time when the company was unable to pay its debts or the company became unable to pay its debts as a result of entering into the transaction. The transaction will not be set aside if the court is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and there were reasonable grounds for believing that the transaction would benefit the company.
- **Unfair preferences.** An unfair preference is any action taken by the company, influenced by a desire to prefer, and that puts one creditor in a better position in the event of insolvency than it would otherwise have been. For the transaction to be set aside, it must have been entered into within a specified time prior to the commencement of the liquidation. The transactions caught are usually those that take place during the six-month period before the company winding up is commenced, but this can be extended to a two year period if the recipient is a person connected with the company. Transactions involving persons connected with the company are presumed to be an unfair preference unless proven otherwise.
- **Extortionate extensions of credit to the company.** An extension of credit to the company within three years before the commencement of the winding up may be set aside upon the application of a liquidator if, having regard to the risk accepted by the person providing the credit, the terms of it are such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of credit, or if it otherwise grossly contravenes ordinary principles of fair dealing.
- Floating charges granted by the company within:
 - two years before the company's winding-up commenced (if granted in favour of a person who is connected with the company); or
 - 12 months before the company's winding-up commenced (if granted in favour of a non-connected person) and the company was unable to pay its debts at the time it was granted or became unable to pay its debts as a result, save to the extent of any new money provided to the company in return for the charge.
- **Transactions made with the intention to defraud creditors or for a fraudulent purpose.** For example, a transaction can be set aside if the liquidator establishes that it took place with the aim of placing assets beyond the reach of creditors. If the property disposed of is held by a bona fide third party purchaser for value and without notice of the fraud, then the transaction will not be set aside.

With the approval of the court and within 12 months of the commencement of the liquidation, the liquidator can also disclaim onerous property of the company, including:

- Unprofitable contracts.
- Land burdened with onerous contracts.
- Property that is not ready to be sold because it binds the possessor to the performance of any onerous act, or to the payment of money.

The court will try to minimise the effect of the disclaimer on third parties, and persons who suffer loss as a result of the disclaimer will become creditors of the company.

CARRYING ON BUSINESS DURING INSOLVENCY

11. In what circumstances can a debtor continue to carry on business during rescue or insolvency proceedings? In particular, who has the authority to supervise or carry on

the debtor's business during the process and what restrictions apply?

Workout

The company can continue to trade, subject to the terms of the workout arrangements. The company's management does not change during an informal workout. Once a workout is agreed, the company will operate under the terms of its arrangement. A committee of creditors can be formed to monitor implementation.

Scheme of arrangement

The company can continue to trade, and the company's management will remain in place. A scheme administrator may be appointed to implement the scheme of arrangement.

Members' voluntary liquidation

The company must cease business operations once a members' voluntary liquidation is underway. The directors' powers will cease, with the exception of powers relating to the company general meeting, or with the agreement of the liquidator. The company can continue business operations only when it is necessary to benefit the liquidation.

Creditors' voluntary liquidation

The company must cease business operations once a creditors' voluntary liquidation is underway. The directors' powers will cease, with the exception of powers relating to the company general meeting, or with the agreement of the committee of inspection, if there is one, or otherwise the creditors. The company can continue business operations only when it is necessary to benefit the liquidation.

Compulsory liquidation

The powers of the directors cease when the winding-up order is made. The liquidator then takes control of the company's property. In order for the liquidator to continue business operations, the approval of the court or the committee of inspection is required. The company can continue business operations only when it is necessary to benefit the liquidation.

ADDITIONAL FINANCE

12. Can a debtor that is subject to insolvency proceedings obtain additional finance both as a legal and as a practical matter (for example, debtor-in-possession financing or equivalent)? Is special priority given to the repayment of this finance?

A company in liquidation is not prohibited from obtaining additional finance. A liquidator can raise funds on the security of the unsecured assets of the company. The security will then take priority in accordance with the general rules on creditors' claims. Such security will not take priority over a pre-existing security interest without the pre-existing security holder's consent.

MULTINATIONAL CASES WHERE THERE ARE NO APPLICABLE EU OR INTERNATIONAL FRAMEWORKS

13. What are the rules that govern a local court's recognition of concurrent foreign restructuring or insolvency procedures for a local debtor? Are there any international treaties or EU legislation governing this situation? What is the process for applying for local recognition where there are no applicable EU or international frameworks?

What are the procedures for foreign creditors to submit claims in a local restructuring or insolvency process?

Recognition

There are no statutory provisions dealing with the recognition of foreign insolvency and rescue procedures in Hong Kong. However, where a foreign company is in liquidation in its country of incorporation, it may be possible to obtain a winding up order in Hong Kong ancillary to that being conducted abroad. The Hong Kong liquidator will generally be responsible for realising the Hong Kong assets and paying over those assets to the principal liquidators abroad.

Similarly, and under principles of international comity, the Hong Kong courts will, in certain circumstances, recognise insolvency procedures and orders made by foreign courts against a local debtor. Problems often arise in Hong Kong in relation to the insolvency and restructuring of mainland Chinese companies, as there is currently no formal arrangement for recognition of insolvency procedures between Hong Kong and Mainland China.

While there is currently no statutory provisions in relation to cross-border insolvency and restructuring in Hong Kong, Hong Kong courts have developed certain common law principles which in effect provide for the recognition of overseas insolvency office holders and the grant of assistance to them in certain circumstances. In particular, the court:

- Can recognise collective insolvency proceedings (including voluntary liquidations). At the time of writing, recognition has been limited to collective insolvency proceedings (and insolvency officeholders appointed therein) commenced in a company's place of incorporation outside of Hong Kong. However, the Hong Kong courts have recently found that there is no doctrinal reason why the courts could not recognise insolvency proceedings commenced in a place which is not the company's jurisdiction of incorporation (for example, the place where a company had its centre of main interests).
- Can grant assistance in Hong Kong to overseas insolvency office holders in a recognised foreign insolvency proceeding.
- Has power to grant assistance, but only to the extent necessary for the performance of an overseas insolvency office holder's functions. The assistance is not available to enable the office holder to do something that he/she could not do under the law by which he/she was appointed. There is also an overarching requirement that an order granting assistance must be consistent with the substantive law and public policy of Hong Kong.

Common law assistance has been granted by the Hong Kong court to office holders appointed in jurisdictions including Australia, Bermuda, the Cayman Islands, the British Virgin Islands, Japan, and Mainland China.

Concurrent proceedings

In appropriate cases and on appropriate terms the Hong Kong court will co-operate with a foreign court if there is concurrent rescue or insolvency proceedings in another jurisdiction.

International treaties

UNCITRAL Model Law on Cross-Border Insolvency 1997 (UNCITRAL Model Insolvency Law) has not yet been implemented in Hong Kong. Hong Kong is not a party to any other relevant international treaties on the subject of insolvency (see *Question 14*).

Procedures for foreign creditors

Claims procedures in local insolvency proceedings are the same for both domestic and foreign creditors.

REFORM

14. Are there any proposals for new legislation or other reform in the context of restructuring and insolvency processes?

Corporate rescue

There are currently no corporate rescue procedures in Hong Kong. In the absence of a voluntary agreement between the company and all of its creditors, a company in Hong Kong only has recourse to a scheme of arrangement.

The Law Reform Commission of Hong Kong issued a report in 1996 that made detailed proposals to implement a form of provisional supervision. Supervision was intended to be through an independent third party, namely a provisional supervisor, who would take temporary control of the company and work towards a voluntary proposal for creditors with minimal supervision from the court. There would also be a moratorium on creditors' claims during the provisional supervision.

Such proposals have been considered several times since then but to date, have not progressed to legislation. The latest position is that in November 2020, the Hong Kong Government announced that it would present the Companies (Corporate Rescue) Bill to the Hong Kong Legislative Council (LegCo) in early 2021. The Bill provides for the introduction of a statutory corporate rescue procedure (CRP) and insolvent trading provisions in Hong Kong. While the Bill has not yet been approved by LegCo and is still subject to change, it contains several key features (as set out in the Legislative Council Panel on Financial Affairs briefing note dated 2 November 2020).

Objects. The objects of CRP are:

- To maximise the chances of a company that is insolvent or is likely to become insolvent continuing in existence as a going concern or as much as possible of its business continuing in existence.
- If it is not reasonably practicable to achieve the above object, to achieve a better return for the company's creditors as a whole than would result from an immediate winding-up of the company.

Commencement. A company that is insolvent or will likely become insolvent may initiate a CRP (either by resolution of its members or directors) and appoint a provisional supervisor.

Provisional supervisor. The provisional supervisor must be an independent professional third party who is either a certified public accountant or a solicitor. The provisional supervisor will displace the management of the company and act as its agent during the moratorium period (see *below*). The provisional supervisor has control of the company's business, property and affairs and the power to terminate or dispose of all or part of the company's business or property during the moratorium period (among other things).

Moratorium. From the appointment of the PS, a 45-business day moratorium on civil proceedings and actions against the company and its property will be triggered (subject to certain exemptions). This period can be extended by up to 6 months with the consent of the creditors and by longer periods with the approval of the court.

Secured creditors. CRP can only be commenced if the company's major secured creditor(s) does not issue a notice of objection within

five business days after it has been informed of a company's intention to initiate the CRP.

Rescue plan. During the moratorium period, the provisional supervisor will investigate the company's business, property, affairs and financial circumstances so as to prepare a rescue proposal (called a voluntary arrangement) for consideration at a creditors' meeting at the end of the moratorium period. Approval of a voluntary arrangement would require the affirmative vote of a majority of creditors in number representing more than two thirds in the value of the claims of creditors present and voting. If approved, the voluntary arrangement will be implemented under the supervision of a supervisor.

Applicable companies. The CRP will be applicable to both Hong Kong companies and registered non-Hong Kong companies (although in the case of the latter, leave of the court will be required to commence a CRP).

Employee protection. The proposed regime also includes certain protections for employees such as a phased payment scheme regarding outstanding entitlements owed to employees at the commencement of the provisional supervision. Failure to make a phased payment will render the moratorium ineffective against the relevant employee who may then petition the court to wind up the company.

Insolvent trading provisions. The Companies (Corporate Rescue) Bill contains insolvent trading provisions which render a director liable for the debts of a company incurred while insolvent (or for a debt which caused the company to become insolvent) unless:

- The director took all reasonable steps to prevent the debt from being incurred.
- When the debt was incurred, the director believed in good faith that the debt was being incurred for the purposes of returning the company to a state of solvency in a reasonable period of time (and there were reasonable grounds for such belief).

Framework for Reciprocal Co-operation between Mainland China and Hong Kong

The Hong Kong Government is also considering a cross-border arrangement between Hong Kong and Mainland China on cross border insolvency and restructuring matters. In June 2020, the Hong Kong Government published a consultation paper setting out details of a proposed framework. Under that framework, it is proposed that Hong Kong would continue to rely on the common law principles developed by the courts (see *Question 13*) to underpin recognition of mainland Chinese "collective insolvency proceedings" and new mainland Chinese legislation based on the UNCITRAL Model Insolvency Law would also be enacted to facilitate recognition of Hong Kong insolvency proceedings. The new legislation would include the following:

- Compulsory winding up commenced under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO).
- Creditors' voluntary winding up commenced under the CWUMPO.
- Schemes of arrangement for restructuring debt, sanctioned by the Hong Kong court under section 673 of the Companies Ordinance (Cap. 622).

It is not yet precisely clear when a cross-border arrangement between Hong Kong and Mainland China will be entered into but it is anticipated that this will occur in the near future.

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