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Restructuring and Insolvency in Hong Kong

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In Hong Kong, the statutory framework for regulating the affairs of insolvent companies is found in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (the "**C(WUMP)O**") and the Companies (Winding Up) Rules (Cap. 32H). The C(WUMP)O also cross-refers to and incorporates certain provisions of the Bankruptcy Ordinance (Cap. 6).

This chapter provides a broad overview of the restructuring and insolvency regime in Hong Kong, including: (i) the options available for companies in financial distress, (ii) the key considerations for stakeholders in an insolvency scenario, (iii) the existing approach to cross-border insolvencies under Hong Kong law, and (iv) the status of proposed legislative reforms.

I. WHAT OPTIONS ARE AVAILABLE FOR COMPANIES IN FINANCIAL DISTRESS?

A. RESTRUCTURING WITHOUT A WINDING-UP

Currently, there is no formal corporate rescue procedure under Hong Kong law. Pursuing informal workouts or schemes of arrangement are the two main ways by which a Hong Kong company in financial distress may restructure its debts without going through a winding-up.

1. Informal workout

A workout comprises contractual arrangements between a debtor company and its creditors. Being an out-of-court process, a workout can be conducted at any point in time, even concurrently with a scheme of arrangement. It is up to the parties to agree on an acceptable arrangement. The terms of a workout plan are therefore highly flexible and may include the amendment and extension of a company's debts or the restructuring of its entire capital structure. Creditors may opt for a consensual workout in which the likelihood and/or rate of recovery are higher than if the company were wound up.

2. Scheme of arrangement

A scheme of arrangement is a court-sanctioned compromise/ arrangement between a companyand all its creditors (or a class of them), that is given statutory effect to bind all such creditors, even if they do not all consent to the arrangement. Companies already in liquidation as well as those that are not can use a scheme of arrangement. The scheme procedure involves a three-step process. First, at an initial court hearing, a court decides whether to grant leave for the scheme proponent to convene meeting(s) of creditors. Second, meeting(s) of the company's creditors (or classes of its creditors) are convened for a vote on the proposed scheme. Under Hong Kong law, a majority (that is, over 50%) in number, representing at least 75% in value, of creditors present and voting at a creditors' meeting must vote in favour of the proposed scheme for it to be approved. If there are multiple classesof creditors whose debts would be compromised pursuant to the scheme, all classes must approve the scheme. Third, following the creditors' approval of the scheme, the scheme proponent submits the scheme to the court for final approval. At a second hearing, the court scrutinises compliance with the procedural requirements prescribed

by statute and the fairness of the proposed arrangement between the company and its creditors. Initiation of a scheme process does not activate a moratorium on creditors' actions. This is why creditors' schemes are sometimes coupled with a provisional liquidation, such that companies can take advantage of the statutory moratorium applicable to a provisional liquidation. Even if the company in question is not a Hong Kong company, a scheme may still be sanctioned by the court so long as there is a "sufficient connection" between the foreign company and Hong Kong.

B. WINDING-UP

Under Hong Kong law, a winding-up, also known as liquidation, can be categorised into three types — members' voluntary liquidation ("**MVL**"), creditors' voluntary winding-up ("**CVL**"), and compulsory winding-up by the courts.

A provisional liquidator may also be appointed to protect the assets of a company at any time after the presentation of a petition for the company's winding-up and before the date on which a winding-up order is made. The appointment of a provisional liquidator triggers an automatic stay on legal actions or proceedings against the company subject to the leave of thecourt. This stay does not affect the rights of secured creditors to enforce their security. The court may exercise its discretion to appoint a provisional liquidator if it is satisfied that there is good *prima facie* case for the winding-up order and that the company's assets are in jeopardy. Whilst the powers of a provisional liquidator may include exploring a restructuring of the company; in Hong Kong, a provisional liquidator cannot be appointed solely for this purpose.

1. When the company is solvent: members' voluntary winding-up

Directors of a solvent but defunct company may initiate an MVL by (i) signing a certificate of solvency that declares that the company will be able to pay its debts in full within 12 months after commencement of the winding-up, and (ii) convening a shareholders' meeting to consider resolutions for the winding-up and for the appointment of a liquidator. A director who signs a certificate of solvency without reasonable grounds is liable to a fine and/or imprisonment (the absence of reasonable grounds is presumed if down the line creditors cannot be paid in full within 12 months). Once the company's affairs have been fully wound up, the liquidator will draw up an account of the MVL and call a final shareholders' meeting. The company will be formally dissolved three months after the date on which the liquidator's final statement of account and the return of the final meeting are registered with the Companies Registry.

2. When the company is insolvent: CVL and compulsory winding-up

There are two types of insolvent winding-up — CVL and compulsory winding-up. Although "insolvency" is not expressly defined under Hong Kong law, the test for insolvency is whether a company in a winding-up petition is unable to pay its debts. Under section 178(1) of the C(WUMP)O, a company is deemed to be unable to pay its debts if (i) it fails (for a period of three weeks) to pay, secure, or compound for (to the reasonable satisfaction of the creditor) a sum equal to or exceeding HK$10,000, which is then due and which has been the subject of a statutory demand; (ii) it fails to satisfy (in whole or in part) an execution or other processes issued on a judgment, decree, or order of any court in favour of a creditor; or (iii) it is proved to the satisfaction of the court that the company is unable to pay its debts, taking into account the prospective and contingent liabilities of the company.

a. Creditors' voluntary winding-up: A CVL is usually initiated after the company's directors determine that the company is insolvent and unable to carry on trading. The directors will resolve that a winding-up is necessary and call a shareholders' meeting, at which a special resolution to wind up the company, and a resolution nominating a liquidator, will be voted on. Around the same time, the company will call a meeting of creditors (which must be held within 14 days of the shareholders' meeting) at which creditors may (amongst other things) nominate their own liquidator and vote to establish a committee of inspection to supervise the liquidation. During a CVL, the powers of the directors are suspended, and the liquidator may exercise powers in relation to the company, as prescribed by the C(WUMP)O. There is no automatic stay on proceedings or creditors' actions in a CVL, but the liquidator or any contributory or creditor may apply to the court for directions or other orders. The liquidator will, to the extent possible, realise all of the company's assets and distribute the proceeds to creditors in accordance with the statutory priorities set out in the C(WUMP)O. As soon as the company's affairs are fully wound up, the liquidator will call a final general meeting of the company and make the requisite filings with the Companies Registry to dissolve the company. Section 228A of the C(WUMP)O prescribes a special procedure by which directorsmay commence a winding-up without first holding a shareholders' meeting. This procedure is available only if it is not reasonably practical for the winding-up of the company to commence under another section of the C(WUMP)O. In practice, the procedure is rarely deployed.

b. Compulsory winding-ups: A compulsory winding-up may be instigated by the debtor company, shareholders, liquidators and, most commonly, creditors whose statutory demand has not been paid or satisfied within 21 days of it being served. The procedure commences with a presentation of a winding-up petition to the court. Once the court is satisfied that one of the grounds set out in section 177(1) of the C(WUMP)O is established (including where the company is unable to pay its debts), it may make a winding-up order against the company. The court may consider the wishes of creditors and what is just and equitable. During a compulsory liquidation, there is an automatic stay on all proceedings and creditors' actions against the company, unless the court grants leave for such proceedings to commence or continue. Again, the directors' powers will be suspended and the court-supervised liquidator will be tasked with realising and recovering the company's assets, investigating thecompany's affairs, adjudicating creditors' claims, and making distributions to creditors out of the liquidation estate. Once the company is fully wound up, the liquidator will apply to the court for a release and for dissolution of the company.

II. STAKEHOLDERS' ROLES AND CONSIDERATIONS IN A LIQUIDATION

A. DIRECTORS AND OFFICERS

It is important for directors and officers of a financially distressed company to be aware of their obligations in an insolvency scenario, as failure to comply with such obligations could result in civil or even criminal liabilities.

A director owes duties to the company, which apply regardless of the company's solvency position. These include, amongst others, the duty to act honestly and in good faith in the interests of the company as a whole; notably, when a company is nearing insolvency, the interests of the company as a whole will encompass the interests of the company's creditors. Directors and officers must also adhere to their fiduciary duties. Should a director or officer commit a breach of any such duties, a subsequently appointed liquidator may bring actions against them on behalf of the company.

There is currently no provision for insolvent trading under Hong Kong law. In other words, directors will not be personally liable for the debts incurred by the company whilst it is insolvent, even if the company subsequently goes into liquidation and there are insufficient assets to pay all creditors in full. However, if a company makes a payment out of capital in respect of the redemption or buy-back of any of its own shares from a shareholder, and a winding-up of the company is commenced within one year after that payment, the directors who signed the solvency statement in relation to the payment out of capital could be jointly and severally liable with the recipient-shareholder to contribute to the assets of the company.

B. SHAREHOLDERS

Shareholders often stand to lose the most in a liquidation scenario, receiving nil or very little return on their shares. In addition, shareholders may face claw-back risks in respect of shares redeemed or bought back within a year before the commencement of a winding-up, any unlawful dividends received whilst the company is insolvent, and any other benefits or property received from the company as part of a transaction at an undervalue or a fraudulent conveyance.

Once a winding-up petition is filed, any subsequent transfer of shares in the company or alteration in the status of its members is void, unless the court otherwise orders.

C. CREDITORS

Creditors who are assessing their options vis-à-vis an insolvent or potentially insolvent company — including petitioning for the company's winding-up, enforcement of their security, and/or the restructuring of the company's debts — should understand the risks and opportunities associated with those options and their likely recovery in each scenario.

At a high level, considerations relevant to creditors in a liquidation scenario include the following:

1. Priority of payment

Generally speaking, the priority of payments in the winding-up of a company in Hong Kong is as follows:

1.	Secured creditors vis-à-vis secured assets (save that, where the company's unsecured assets are insufficient to meet the preferential debts listed in s.265(1) of the C(WUMP)O, the Company's floating charge assets will be applied first in satisfaction of those preferential debts before being paid to the floating charge holders)
2.	Expenses of the winding-up (including the liquidators' remuneration)
3.	Preferential debts as defined in s.265(1) of the C(WUMP)O, including: • Employee entitlements (subject to limits) • Government debts
4.	Unsecured creditors (on a pari passu basis)
5.	Interests of debts (for the period after the company went into liquidation)
6.	Subordinated creditors (such as members in respect of debts due to them from the company in their capacity as members)
7.	Members of the company generally

2. Stays and moratorium

In a compulsory winding-up, court proceedings and legal actions against the company are stayed, subject to the court granting leave for their commencement or continuation. Instead, unsecured claims against the company are replaced by creditors' entitlements to prove in the winding-up and to receive distribution of dividends out of the company's estate.

Notwithstanding that, the liquidation of a debtor-company will not prevent a secured creditor from enforcing its security.

3. Claw-back risks

Once a winding-up petition is filed against a company, any disposition of the company's property, including things in action, is void, unless the court otherwise orders.

In addition, creditors who had received payments, grants of security (in particular, floating charges), and/or transfers of assets from an insolvent company could face claw-back risks in respect of such transactions in the event that the company subsequently goes into liquidation. The key categories of voidable transactions are unfair preferences, transactions at an undervalue, extortionate credit transactions, fraudulent trades, and floating charges granted within a certain period prior to the commencement of the winding-up.

4. Prospect of restructuring

Whilst a restructuring may be implemented in the context of a provisional liquidation or even a formal liquidation, and some creditors may choose to use a winding-up petition to pressure an insolvent company into progressing a restructuring, creditors should bear in mind that:

- The commencement of a winding-up petition (even if the petition is subsequently withdrawn) could potentially have adverse impacts on the prospects of a successful restructuring (e.g. it might trigger defaults/termination of other indebtedness or material contracts); and
- Under Hong Kong law (as it currently stands), a provisional liquidator cannot be appointed to a company solely for the purpose of a corporate rescue.

5. Available assets and potential recovery

The likely return to creditors in a liquidation will depend heavily on: (i) the available assets of the company; (ii) the ease with which, and the amount of, those assets that could be recovered and realised; (iii) out of those assets, the proportion that represents secured assets (that will be used exclusively to meet secured liabilities); and (iv) the availability of liquidators' recovery actions and the likelihood and time required to prosecute those claims and achieve actual recoveries.

6. Outstanding liabilities

The total quantum of provable claims against the company that will share, on a *pari passu* basis, in the distribution of available assets is equally important to the likely return to creditors.

7. Likely delay

Creditors should bear in mind that typically there is a long delay between the commencement of a winding-up and the actual distribution of a dividend (including interim dividends) to creditors. The delay may be caused by difficulties faced by the liquidator in recovering and realising assets and/or complexities (including court proceedings) in connection with the adjudication of claims.

III. CROSS-BORDER INSOLVENCY CASES

Hong Kong is uniquely positioned between the PRC and other offshore jurisdictions, and most insolvency cases in Hong Kong involve cross-border elements. A classic example is when a holding company incorporated in an offshore jurisdiction (such as the BVI, Bermuda, or the Cayman Islands) would be listed on the Hong Kong Stock Exchange and would have shareholding in one or more PRC subsidiaries. The Hong Kong-listed holding company would hold little or no physical assets but could issue bonds (which may be governed by English or New York law) or take loans from banks. The funds so raised would flow down from the holding company to the PRC subsidiaries that would, in turn, hold physical assets in China and operate the actual business. If the holding company is unable to pay its debts, complex cross-border insolvency issues will arise. Below is a summary of some of those issues and the Hong Kong court's current approach to them.

A. WINDING-UP FOREIGN COMPANIES IN HONG KONG

A company incorporated outside of Hong Kong may be wound-up by a Hong Kong court under section 327 of the C(WUMP)O if, amongst other things, the company is unable to pay its debts or if the court is of the opinion that it is just and equitable that the company be wound-up.

In addition, the courts, as a matter of discretion, have generally required three conditions to be satisfied before winding-up a foreign company, namely: (i) the company has sufficient connections with Hong Kong (which typically comprise the presence of assets in the jurisdiction); (ii) there is a reasonable possibility that the winding-up order would benefit those applying for it; and (iii) the Hong Kong court is able to exercise jurisdiction over one or more persons in the distribution of the company's assets. In exceptional circumstances in which the connection with Hong Kong is so strong and the benefits of a winding-up to creditors are so substantial, a court may order a winding-up even though the third criterion might not be satisfied.

B. RECOGNITION OF AND ASSISTANCE TO FOREIGN PROCEEDINGS

To date, Hong Kong has not enacted the UNCITRAL Model Law on Cross-Border Insolvency. As a result, foreign insolvency practitioners must resort to the Hong Kong court's common law jurisdiction for the recognition of, and assistance to, foreign insolvency proceedings. Typically, a foreign insolvency practitioner would apply to the foreign court (i.e. the court of the jurisdiction in which the insolvency proceeding was commenced) for a letter of request addressed to the Hong Kong court, requesting that assistance be granted to the practitioner (e.g. to protect assets located in Hong Kong). Having obtained that letter of request, the practitioner would apply to the Hong Kong court for the requisite relief.

The Hong Kong court has taken a fairly generous view of its power to assist foreign insolvency proceedings, including provisional liquidations commenced offshore solely for the purpose of restructuring.[1] However, that power remains limited by common law and equitable principles, and the relief that the court may grant is limited to those that would be available to a liquidator under Hong Kong's insolvency law.[2]

As between Hong Kong and the PRC, on 14 May 2021, the PRC Supreme People's Court (the "SPC") and the Hong Kong Department of Justice signed a Record of Meeting on Mutual Recognition of Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and of the Hong Kong Special Administrative Region.

Even before that Record of Meeting was signed, the Hong Kong court was already making recognition orders and granting assistance sought by mainland bankruptcy administrators.[3] With the signing of the Record of Meeting (coupled with opinion and the practical guide published by the SPC and the Hong Kong government, respectively), a Hong Kong liquidator/provisional liquidator may now seek recognition by, and assistance from, the People's Courts in Shanghai, Xiamen and Shenzhen in respect of a Hong Kong liquidation, provisional liquidation, or scheme of arrangement (as approved by a Hong Kong court), provided that the debtor company has had its centre of main interest in Hong Kong for a continuous six-month period at the time of the application. Interim preservation orders may also be sought from the PRC courts at any time after a recognition application has been filed. Once the Hong Kong insolvency proceedings are recognised by the PRC court, there will be a moratorium on creditors' claims and actions in the mainland, and the PRC court may confer powers on the Hong Kong liquidator to, amongst other things, take control of the debtor's books and assets and investigate the debtors' affairs.

C. CROSS-BORDER SCHEMES OF ARRANGEMENT

If cross-border elements are involved in a scheme of arrangement, the Hong Kong court will consider whether there is sufficient connection between the scheme and Hong Kong, and whether the scheme is effective in other relevant jurisdictions, because it would not be a proper exercise of the discretion to sanction a scheme that serves no purpose.[4] Relevant to that second consideration is the rule in *Gibbs*, which provides that a discharge of a debt is not effective unless it is in accordance with the law governing the debt. In that regard, the Hong Kong court has generally followed the rule in Gibbs, with certain exceptions (e.g. where the foreign creditor(s) had submitted to the Hong Kong court's jurisdictions).[5]

Separately, it has become an established practice for Hong Kong-listed companies incorporated offshore to use parallel schemes of arrangement (approved by courts both in Hong Kong and in the offshore jurisdiction) to restructure their debts. This is to ensure that creditors do not disrupt the operation of the scheme by taking hostile action against the company in either jurisdiction. However, the courts have criticised this practice of parallel schemes as being an outmoded way of conducting cross-border restructuring, and have called for better international coordination to enable a substantive recognition of foreign schemes of arrangement in offshore jurisdictions.[6]

[1] Re Z-Obee Holdings Ltd [2018] 1 HKLRD 165.
[2] The Joint Administrators of African Minerals Ltd (in administration) v Madison Pacific Trust Ltd [2015] HKCU 875.
[3] Re CEFC Shanghai International Group Limited [2020] HKCFI 167; Re Shenzhen Everich Supply Chain Co Ltd [2020] HKCFI 965.
[4] Da Yu Financial Holdings Limited [2019] HKCFI 2531.
[5] China Lumena New Materials Corp (in provisional liquidation) [2020] HKCFI 338.
[6] Re Da Yu Financial Holdings Limited [2019] HKCFI 2531.

IV. LEGISLATIVE REFORMS

In November 2020, the Hong Kong government announced its plans to introduce the Companies (Corporate Rescue) Bill (the "**Bill**") in early 2021. The Bill aims to introduce a statutory corporate rescue procedure and insolvent trading provisions into Hong Kong law. Key features of the Bill include:

- *Provisional supervision:* a company that is insolvent or will likely become insolvent may appoint an independent third party as provisional supervisor with the support of the company's major secured creditor. During the provisional supervision period, the provisional supervisor will take control of the company, consider options for rescuing the company and, where appropriate, prepare proposals of a voluntary arrangement for approval by the company's creditors.

- *Statutory moratorium:* during the provisional supervision period, there will be a statutory moratorium on civil proceeding and actions against the company, subject to certain statutory exemptions (including certain rights of employees regarding their pay entitlements).

- *Insolvent trading:* subject to statutory defences, a director of a company will be responsible for insolvent trading if the director at the material time knew or ought to have known that the company was insolvent when the debt was incurred or would become insolvent by incurring the debt or other debts incurred at the same time. Uponinsolvent liquidation of the company, the court may order the director responsible for insolvent trading to make a contribution to the company's assets.

When the Bill will be introduced and when these much-needed legislative reforms will be implemented remains to be seen.

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Latham's lawyers represent borrowers, sponsors, banks and distressed investors and other parties on workouts, restructurings, and bankruptcy cases from middle market businesses to the largest multinational enterprises.

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