A&O SHEARMAN

Restructuring across borders
Hong Kong

CORPORATE RESTRUCTURING AND INSOLVENCY PROCEDURES | FEBRUARY 2024

Contents

Introduction

When a corporate borrower in Hong Kong faces financial difficulties, the principal restructuring and insolvency options for companies under Hong Kong law include:

- out-of-court workout;
- schemes of arrangement; and
- liquidation (which may be preceded by the appointment of provisional liquidators).

From a creditor's perspective, the choice of procedure will depend upon whether the borrower has granted security. If security has been granted, receivership may be the most appropriate choice.

If no security has been granted, the creditor must decide whether there is a business to be rescued. If so, an informal bank rescue or workout, outside of any of the formal insolvency procedures, may be appropriate. Alternatively, a scheme of arrangement involving a statutory compromise of the company's debts with its creditors with the sanction of the court may be more appropriate.

If there is no business to be rescued, liquidation, the formal dissolution procedure for Hong Kong companies, may need to be sought.

Creditors with the benefit of security may elect to enforce their security. Security enforcement is essentially a self-help remedy rather than a collective restructuring or insolvency procedure and, if available to a creditor, will often represent the best method of recovery.

Enforcement of security

The main forms of security available under Hong Kong law are:

- mortgage over real property;
- charge over shares;
- assignment over contracts, receivables and intellectual property; and
- fixed and floating charge.

Hong Kong law recognises the concept of trusts, and security trust structures are commonly used in Hong Kong.

Security enforcement in Hong Kong commonly takes place by appointment of a receiver. Receivership is essentially a self-help remedy for secured creditors of the company. It is not a collective insolvency procedure but rather it is a method by which a creditor may enforce its security, realise the secured assets and obtain repayment.

The use of a receiver is popular because receivers may act independently as the agent of the relevant mortgagor/chargor, and this can help insulate the securitytaker from liability that may arise out of the enforcement process.

A receiver may be appointed over specific assets or a receiver and manager may be appointed over the company's whole business. Receivers are usually appointed under the terms of the debenture or security documents in favour of a creditor but may also be appointed by the court. A court may appoint a receiver in a variety of circumstances such as: where a company is shown to be incapable of managing its own affairs; to safeguard or preserve property for creditors; pursuant to a charging order in debt recovery actions; or in relation to a shareholder dispute. In addition, in Hong Kong it may be impossible or impractical for certain forms of security to be enforced through an out-of-court appointment of receivers. In the case of a mortgage over real property, it is often necessary to obtain a court order to ensure that the property is sold with vacant possession. It is also usual for an equitable charge to be enforced by way of court order.

The receiver's powers shall be limited to those set out in the debenture/security document(s) or as specified by the court. Where a receiver and manager have been appointed over the company's whole business, they will usually have wide powers to carry on running the business.

The objective of a receiver (or a receiver and manager) will usually be to sell the asset they are appointed over or the whole business as a going concern (as appropriate), and apply the proceeds of such sale (after deduction of fees, costs and expenses) towards the secured liabilities. The receiver (or receiver and manager) will be subject to a duty to take reasonable care to obtain the best price reasonably obtainable at the time of sale.

Corporate rescue

There is no statutory reorganisation procedure available under Hong Kong law, but it is possible for creditors of a Hong Kong company to attempt to negotiate an informal contractual restructuring agreement with the company. This will generally require the co-operation of all creditors of the company (as any one creditor may still exercise its right to wind up the company). Bank creditors are encouraged to give a financially distressed company the opportunity to negotiate a restructuring by the Approach to Corporate Difficulties issued in 1999 and revised in 2011 jointly by the Hong Kong Association of Banks and the Hong Kong Monetary Authority, the government authority in Hong Kong responsible for the supervision of authorised institutions such as banks. In the absence of co-operation from all creditors, a scheme of arrangement (which does not require unanimous creditor support in order to be capable of being sanctioned and implemented – see below) may help to procure a restructuring which binds all creditors.

Scheme of arrangement

Schemes of arrangement are provided for under Division 2 of Part 13 of the Companies Ordinance (Cap. 622 of the laws of Hong Kong) and involve a compromise or arrangement between a company and its creditors or members (or any class of them). A scheme will require the agreement of over 50% in number and at least 75% in value of creditors and members (or relevant classes of them) present and voting and, if approved by the court, will become binding on all such classes, including those who voted against and those who did not vote at all. The court maintains total discretion on whether to sanction a scheme and will consider, among other things, (i) compliance with the statutory process, (ii) whether the majority approving the scheme is fairly representative of its class and is acting in good faith, and (iii) whether the scheme is fair to all creditors in the circumstances. Where there are different classes of creditors (e.g. contingent or unsecured) each class is required to hold separate meetings to discuss the scheme proposals.

The terms of each scheme of arrangement will vary, however they will often require variation of contractual terms, waiver of part of creditor claims and/or exchanges of debt for equity.

The process by which a scheme of arrangement is sanctioned does not provide any moratorium against creditor action. Creditors therefore retain the ability to seek to enforce their claims through obtaining judgment or to present a windingup petition, although the Hong Kong court has been persuaded to exercise its discretion to refuse to make a winding-up order whilst a restructuring proposal is put to creditors through a scheme.

Other statutory provisions

The Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the Laws of Hong Kong) contains a number of other provisions to assist a company's restructuring such as:

- section 254, which provides a procedure for an arrangement to become binding on a company being, or about to be, wound-up and its creditors without court approval. The section only applies to an "arrangement" rather than the arguably wider concept of an "arrangement or compromise" dealt with by Division 2 of Part 13 of the Companies Ordinance (Cap. 622 of the Laws of Hong Kong). The arrangement will be binding on the company if sanctioned by a special resolution and, on its creditors if acceded to by at least 75% in value and number of all creditors. Any creditor or contributory may appeal to the court to challenge the arrangement;
- section 237, which allows a liquidator to accept shares or other securities in lieu of cash when selling all or part of the business or property of a company in a members' voluntary liquidation. The liquidator may exercise this power only with the sanction of a special resolution of the company. A member of the company may require the liquidator to purchase its shares before proceeding with the transfer; and
- section 246, which applies section 237 to creditors' voluntary liquidations. Section 246 also modifies the procedure slightly by requiring the approval of the court or committee of inspection, which is a body appointed to supervise the liquidation, before a liquidator may exercise the power.

Liquidation

Liquidation (or winding-up) is the dissolution procedure for companies under Hong Kong law. Liquidation can take one of two forms:

- voluntary liquidation, a procedure conducted out of court, which generally occurs where the shareholders of a company pass a resolution to place the company into liquidation. If a majority of the company's directors have made a declaration of solvency stating that the company will be able to pay its debts in full within the 12 months after commencement of the winding-up, the liquidation will be a members' voluntary liquidation. In the absence of such a declaration, the liquidation will be a creditors' voluntary liquidation.

In addition, there is a special procedure under section 228A of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32. of the Law of Hong Kong) for the directors of a company to resolve at a directors' meeting that a company be wound up on the grounds that it cannot, by reason of its liabilities, continue its business; or

- compulsory liquidation, which occurs following the court's acceptance of a petition presented by a company's contributory or creditor, the company itself or certain government officials if one or more of the relevant grounds exist. Such grounds include, amongst others, that the company is unable to pay its debts (which may be deemed in certain circumstances, including where the company has failed to comply with a statutory demand for payment for an undisputed debt), and that it is just and equitable for the company to be wound up.

Upon the commencement of liquidation, a liquidator will take control of the company and collect, realise and distribute its assets to creditors and then to shareholders.

The effect of a liquidation on claims against the company is broadly as follows:

- security and proprietary rights against the company are unaffected and remain enforceable;
- in a compulsory winding-up, once the winding-up order has been made, no action or proceedings can be commenced or proceeded with against the company or its property without the leave of the court. Although there is no equivalent automatic moratorium in the case of a creditors' voluntary liquidation, the liquidator may apply to the court for a stay of such proceedings to ensure an equal distribution of the company's property; and
- claims against the company are crystallised as at the date of liquidation and a proof-of-debt mechanism comes into play, including a mandatory insolvency set-off provision.

When the liquidation process has been completed, the company is dissolved.

Provisional liquidations

Provisional liquidators may be appointed to protect the assets of a company between the date of petition for the company's winding-up and the date on which a winding-up order is made, provided that the court can be persuaded that the assets of the company are in jeopardy. The appointment of provisional liquidators triggers a stay of enforcement of creditors' claims and provisional liquidators have therefore been appointed to assist in exploring a restructuring. This is only possible, however, if there is jeopardy to assets of the company which justifies the appointment of a provisional liquidator in the first place. The stay does not affect the ability of a creditor to accelerate under the terms of a loan facility (to maximise its claim against the company), subject to the right to accelerate arising under the terms of the relevant finance documents (which is usual following an appointment). The stay will also not affect secured creditors, who remain entitled to enforce their security in the normal course.

A provisional liquidator can be contrasted with a liquidator, who is appointed after a winding-up order has been made and are responsible for realisation of the company's assets and later distribution to creditors. The appointment of a provisional liquidator does not automatically terminate contracts to which the company is a party or relieve the company of its contractual obligations unless the contracts themselves contain termination rights. The provisional liquidator's ability and willingness to cause the company to perform its contractual obligations may also be limited. The duty of the provisional liquidator is to the company's creditors generally, rather than to any specific creditor. The provisional liquidator cannot be expected to cause the company to perform obligations which would have the effect of placing a counterparty in an unfairly preferential position to that of other counterparties.

Although the directors of the company remain in office, practically their authority is superseded by the role of the provisional liquidator. It is common for a provisional liquidator to be appointed where the management is no longer capable of effectively running the company.

A provisional liquidator's powers are limited by the terms of his or her appointment order. Although a provisional liquidator must be appointed for the purpose of conducting proceedings in winding-up a company, it is possible for extra powers being given to a provisional liquidator, including those that would enable the presentation of an application for a scheme of arrangement.

A provisional liquidator will remain in office until either (i) the court confirms the appointment of liquidators following the first meeting of creditors or (ii) until the court orders that they be discharged.

Cross border issues

The jurisdiction of the Hong Kong court is not limited to winding up companies incorporated in Hong Kong. A Hong Kong court will accept jurisdiction to liquidate a company not incorporated in Hong Kong where[1]:

- the court is capable of accepting jurisdiction. The Hong Kong court is able to accept jurisdiction in a wide range of circumstances,[2] including if the company is unable to pay its debts; and
- the court is able to exercise that jurisdiction. This requires that (i) the company has a sufficient connection with Hong Kong, (ii) there is a reasonable possibility of benefit accruing to those applying for the winding-up, and (iii) the court is able to exercise jurisdiction over one or more persons interested in the distribution of the debtor's asset.

Hong Kong law does not currently recognise the UNCITRAL Model Law on Cross-Border Insolvency. However, the Hong Kong court has proved flexible and creative in using its common law powers to assist foreign insolvency processes. There is a developing body of case law relating to requests for recognition and assistance, and the Hong Kong court has considered factors such as the existence and location of collective insolvency proceedings, the company's centre of main interests, the necessity and appropriateness of assistance, and conformity with public policy and substantive law.

Most specifically, it is possible to obtain orders of recognition by the Hong Kong court of offshore provisional liquidators (most commonly those appointed for restructuring purposes) and, where and to the extent the Hong Kong court considers it appropriate, of assistance to those provisional liquidators. In the area of cross-border insolvency cooperation between the courts of the Hong Kong SAR and of the mainland of the People's Republic of China (noting that Mainland China is a civil law jurisdiction), the Hong Kong court has granted orders of recognition and assistance in favour of the administrators of companies in bankruptcy administration in Mainland China, and recognising reorganisation proceedings of a Mainland China incorporated company in Mainland China as a collective insolvency proceeding.

In conjunction with this, the Supreme People's Court of the People's Republic of China and the Government of the Hong Kong SAR in May 2021 signed a record of meeting, providing a more general framework for the mutual recognition of and assistance to insolvency proceedings between the PRC and Hong Kong. The framework is to facilitate: (i) Hong Kong liquidators or provisional liquidators to apply to the Intermediate People's Courts in certain pilot areas of the PRC for the recognition of Hong Kong collective insolvency and restructuring proceedings (i.e. compulsory winding-up, creditors' voluntary winding-up and schemes of arrangement); and, reciprocally, (ii) bankruptcy administrators from the PRC also to apply to the High Court of Hong Kong for recognition of Mainland China bankruptcy and reorganisation proceedings. The framework is applicable to Hong Kong insolvency proceedings where Hong Kong is the centre of main interests of the debtor (and can therefore extend to companies not incorporated in Hong Kong). Once the relevant court in the PRC grants recognition and assistance to the Hong Kong insolvency proceedings, the Hong Kong 'administrators' can then, upon application, exercise various powers in the PRC including: (i) managing and disposing of the debtor's property, (ii) taking control of the debtor's property, books and records, (iii) investigating the financial position of the debtor, and (iv) participating in legal proceedings on behalf of the debtor. While this reciprocal arrangement is, for now, limited to the designated pilot areas of the PRC (including Shanghai, Shenzhen and Xiamen), the Hong Kong court continues to use its common law powers in applications for recognition of Mainland China collective insolvency proceedings commenced outside of the pilot areas.

[1] A company incorporated outside Hong Kong may only be liquidated in a compulsory winding-up.
[2] As set out in section 327 (3) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the Laws of Hong Kong).

Reform

A provisional supervision procedure akin to the administration procedure in England and Wales has been under consideration for a considerable period of time. This was recommended by, amongst others, The Law Reform Commission of Hong Kong, and a draft bill was prepared to introduce the procedure (the Provisional Supervision – Companies (Corporate Rescue) Bill) with an expectation that it would be enacted in 2002. However, despite being reconsidered several times in 2003, 2009 and 2014, the legislation has not been enacted. Most recently in November 2020, the draft bill was once again tabled by the Hong Kong Government.

While the bill was scheduled to be presented to the Legislative Council sometime in 2021, discussions on the extent of the reform now required remain ongoing.

Key contacts

If you require advice on any of the matters raised in this document, please contact any of our partners or your usual contact at A&O Shearman, or email **rab@aoshearman.com**.

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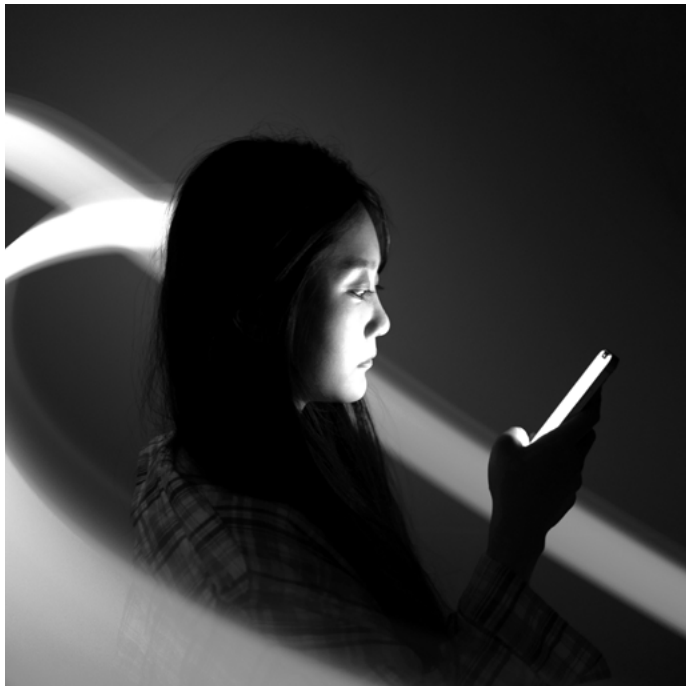
Further information

Developed by A&O Shearman's market-leading Restructuring group, "**Restructuring Across Borders**" is an easy-to-use website that provides information and guidance on all key practical aspects of restructuring and insolvency in Europe, Asia, the Middle East and the U.S.

To access this resource, please **click here**.



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