Is Debtor-in-Possession Viable in Hong Kong?

John Kong Shan Ho* and Raymond Siu Yeung Chan**

Abstract: In October 2009, the Financial Services and the Treasury Bureau of the Hong Kong Government published a consultation paper to review corporate rescue procedure with the aim of reforming key issues relating to corporate rescue. This paper compares the proposed reform in Hong Kong and the debtor-in-possession concept of the United States of America in Chapter 11 corporate rescue, and seeks to identify the reasoning behind the differences.

Keywords: corporate rescue, Chapter 11, corporate governance, corporate insolvency, debtor-in-possession, provisional supervision

I. Introduction

Many economies, whether developed or emerging, have corporate rescue or restructuring laws to preserve the going concern value of ailing corporations. According to corporate rescue experts, the underlying rationale for corporate rescue is that a business may be worth a lot more if preserved, or even sold, as a going concern than if parts are sold off piecemeal.[1] A fire sale of a company or its assets when it could be rescued can effectively harm interests of all stakeholders. Employees will be affected, creditors are likely to get a lesser return and shareholders will also be adversely affected. For this reason, many jurisdictions have developed laws to assist the process of corporate rescue. As The Hon. Mr Rogers V-P of the Hong Kong Court of Appeal puts it in the case of *Re Legend International Resorts Ltd*:[2]

> The rationale of corporate rescue is that, if successful, there is almost certainly likely to be a better return to creditors and also shareholders than if the particular company went into liquidation . . .

Other international institutions also agree with these points; for example, the Legal Department of the International Monetary Fund (IMF) suggests that changes in the nature of our economy from

* Dr John K.S. Ho, Assistant Professor, School of Law, City University of Hong Kong; e-mail: johnksho@cityu.edu.hk.
** Dr Raymond S.Y. Chan, Associate Professor, School of Business, Hong Kong Baptist University.

1 D.G. Baird and R.K. Rasmussen, 'The End of Bankruptcy' (2002) 55 *Stanford Law Review* 751 at 758.
2 [2006] 2 HKLRD 192.

Common Law World Review 39 (2010) 204–218
DOI: 10.1350/clwr.2010.39.2.0204

Electronic copy available at: http://ssrn.com/abstract=1732091

manufacturing-based to service or technological-based has meant that restructuring of ailing firms has become more important than ever before:[3]

> In the modern economy, the degree to which an enterprise's value can be maximized through liquidation of its assets has been significantly reduced. In circumstances where the value of a company is increasingly based on technical know-how and goodwill rather than on its physical assets, preservation of the enterprise's human resources and business relations may be critical for creditors wishing to maximize the value of their claims.

The global financial crisis 2008 has led to the collapse of many financial institutions and corporations worldwide. Apart from injecting billions of capital to revitalize market confidence, governments are also taking the initiative in reforming and implementing rescue frameworks to bail out corporations. As one of the world's major financial centres, Hong Kong has not been immune from the crisis and corporate failures are starting to emerge and likely to continue. In October 2009, the Financial Services and the Treasury Bureau (FSTB) of the Hong Kong Government published a consultation paper to review corporate rescue procedure with the aim of reforming key issues relating to corporate rescue. This paper is written against this background, and is divided into three main sections. Section II discusses the main features of corporate rescue law in the United States (US) focusing on the nature of its debtor-in-possession (DIP) concept. Section III discusses the current corporate rescue procedure in Hong Kong and the reform proposed by the Hong Kong FSTB. In section IV, there is an analysis and discussion which seeks to identify the differences between the DIP concept with the proposed reform in Hong Kong from a law and economics perspective. In the final analysis, it is argued that due to the history and nature of its economy, it is impractical for Hong Kong to adopt the DIP concept.

II. Corporate Rescue in the US Bankruptcy Code

Corporate rescue or restructuring proceedings in the US are regulated by Chapter 11 of the Bankruptcy Code 1978. They are usually commenced by a voluntary petition filed by the corporate debtor, which brings about a moratorium on enforcement proceedings against the debtor company or its property.[4] There is no requirement of insolvency before a company can enter the Chapter 11 process but a case can be dismissed early if it has been filed in *mala fide* or without reasonable hope of success. Chapter 11 is generally considered to be

3 Legal Department, International Monetary Fund, *Orderly and Effective Insolvency Procedures* (1999) 14.

4 G. McCormack, 'Control and Corporate Rescue—An Anglo-American Evaluation' (2007) 56 *International and Comparative Law Quarterly* 515 at 517.

Electronic copy available at: http://ssrn.com/abstract=1732091

pro-debtor rather than pro-creditor in the sense that the existing management of the company seeking protection from its creditors is not displaced in favour of some court-appointed outsider. The management itself can prepare a reorganization plan and put it to creditors and shareholders and there is a specific mechanism for the financing of the company during a Chapter 11 period which may include the 'trumping' of existing security interests and finally, in certain circumstances, secured creditors can be 'crammed down' (forced to accept a reorganization plan against their wishes).[5]

The distinctive feature of Chapter 11 rescue is that the incumbent management generally remains in place. Some commentators suggest that at this stage the management is legally transformed into a quasi-trustee in bankruptcy,[6] and this is generally referred to as debtor in possession (DIP). The DIP can run the company in the ordinary way but will require court approval for substantial asset sales. For the first few months, only the DIP can propose a reorganization plan, but thereafter any creditor may do so. Creditors need to approve a plan which requires a majority in number, and two-thirds in amount, of each class of creditors. Every impaired class of creditors must approve the plan, though 'cram-down' is possible.[7] In general, a secured class of creditors may be crammed down if it receives the value of its collateral, plus interest, over time, while an unsecured class may insist that shareholders receive nothing if a plan is to be approved despite its objection. Objecting creditors are protected by the 'best interests' rule, that is, each objecting creditor must receive at least as much under the plan as it would in liquidation, and also a feasibility test, i.e. the company must be reasonably likely to be able to perform the promises it makes in the plan. The US Supreme Court itself has described the objectives of Chapter 11 as a policy where the business can continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners.[8]

The DIP concept is a unique feature of the US corporate rescue law which differentiates it from other jurisdictions. Despite similar legal traditions and economic systems, corporate restructuring is not the same process in the United Kingdom (UK), Australia or Canada as it is in the US. In the US, there seems to be a different attitude towards risk and risk-takers. A leading empirical study by two prominent US bankruptcy lawyers and a sociologist concluded that bankruptcy debtors

5 G. McCormack, 'Corporate Rescue Law in Singapore and the Appropriateness of Chapter 11 of the US Bankruptcy Code as a Model' (2008) 20 *Singapore Academy of Law Journal* 396 at 406.
6 Above n. 4 at 518.
7 J. Friedman, 'What Courts do to Secured Creditors in Chapter 11 Cram Down' (1993) 14 *Cardozo Law Review* 1496 at 1499.
8 *US* v *Whiting Pools Inc* [1983] 462 US 198.

are not outliers in society but people we know. They are merely ordinary people who are victims of America's market-driven, highly competitive, compulsively consuming and anti-welfare environment.[9] The DIP concept is regarded as a motivating factor for directors of many companies in the US. They know that filing for Chapter 11 protection will safeguard their position as well as provide them with the exclusive right to propose a restructuring plan. In other words, early filing in the US is encouraged by the carrot of retaining control of the company and acquiring the DIP status. The DIP can run the business in the ordinary way but will need court approval for substantial asset sales.

Under section 1107 of the US Bankruptcy Code, the debtor-in-possession has all the powers of a bankruptcy trustee and this was confirmed by the US Supreme Court in the case of *Commodity Futures Trading Commission* v *Weintraub*.[10] It is only under exceptional circumstances that an outside trustee will be appointed to take over the management of the company for cause.[11]

However, there is the general law on directors' duties and in a growing number of US cases where courts have held that managerial allegiance must shift from shareholders to creditors when a company approaches insolvency.[12] Upon insolvency, the residual claims of shareholders become economically worthless and creditors, who will go unpaid in the event of complete financial failure, now occupy the position of residual owners.[13] Other influential judicial statements in the US also emphasize that in the vicinity of insolvency, the board of directors has an 'obligation to the community of interests' that sustained the corporation to exercise judgment in an informed good faith effort so as to maximize the corporation's long-term wealth-creating capacity.[14]

The goal of Chapter 11, as mentioned earlier, is to achieve a consensual plan of reorganization accepted by certain requisite majorities of various classes of impaired creditors and equity holders. This is because a 'going concern value' may be worth a lot more than the break-up value. Reorganization proceedings are designed to keep a business alive so that this additional value can be captured.

However, some commentators believe that the objective of corporate rescue is itself controversial. If a company is producing goods or services for which there is no ready market, then why should it not be liquidated?[15] Further, preserving dying companies or putting them on

9 T. Sullivan, E. Warren and J.L. Westbrook, *The Fragile Middle Class: Americans in Debt* (Yale University Press: New Haven, 2000).
10 [1985] 471 US 343 at 355.
11 See section 1104(a)(1) of the US Bankruptcy Code for details.
12 *Federal Deposit Insurance Corp* v *Sea Pines Co* [1982] 692 F 2d 973 at 976–7.
13 *Geyer* v *Ingersoll Publications Co* [1992] 621 A 2d 784 at 787.
14 *Credit Lyonnais Bank Nederland NV* v *Pathe Communications*, No. CIV.A. 12130, 1991 Del Ch.
15 Above n. 5 at 397.

a life support machine may do little to benefit the industry in which they operate. It may hurt competitors by forcing them to compete with debt-reduced and restructured companies that are still inefficient, in a crowded or saturated market-place. The US airline industry is a good example of this.[16]

Moreover, the concept of DIP has been held to encourage wasteful, strategic behaviour by company directors. That is, the management personnel who originally put the company into financial difficulties have not only the incentive but also the power and authority to initiate high-risk strategies. They have nothing to lose and possibly a lot to gain by speculative investment of the company's resources.

Compared to other advanced economies with a similar legal tradition, the US approach towards corporate restructuring is by far the most lenient towards existing management. Other common law jurisdictions such as the UK or Australia are far more sceptical of the DIP concept than Americans.[17] In the UK, a dedicated corporate rescue procedure did not really exist until the mid-1980s with the implementation of the Insolvency Act (IA) 1986. The IA 1986 has been amended on many occasions, notably by the IA 2000, introducing new rules on company voluntary arrangements and allowing for a moratorium. Further, the Enterprise Act (EA) 2002 provides a new regime for administration, restricting the right to appoint administrative receivers, and substantially changed the rules for distribution of company assets on liquidation.[18]

The focus of corporate rescue in the US is on balancing the desires of creditor groups, debtor groups, and promoting commerce. However, in other parts of the common law world such as the UK and Australia, business failure is perceived far more negatively than in the US. This is because, in the US, business failure is very often thought of as the result of misfortune rather than wrongdoing.[19] Also, when the US Bankruptcy Code was advanced during the legislative debates, it recognized the need for the debtor to remain in control to some degree or else debtors will avoid the reorganization provisions in the Bill until it would be too late for them to be an effective remedy.

Having examined the US corporate rescue framework and the rationale behind the DIP concept, the paper now turns its focus on the present corporate rescue procedure in Hong Kong and its underlying problems, and the reform proposed by the FSTB.

16 *Ibid*. at 398.
17 N. Martin, 'Common-Law Bankruptcy Systems: Similarities and Differences' (2003) 11 *American Bankruptcy Institute Law Review* 367–410.
18 L. Sealy and S. Worthington, *Cases and Materials in Company Law* (Oxford University Press: Oxford, 2008) 629.
19 G. Moss, 'Comparative Bankruptcy Cultures: Rescue or Liquidations? Comparisons of Trends in National Law—England' (1997) 23 *Brooklyn Journal of International Law* 115.

III. Current Corporate Rescue Procedure in Hong Kong and Proposed Reform

Due to its colonial history, Hong Kong's insolvency law has largely been influenced by the UK system. In respect to corporate insolvency, the rules are largely to be found in Parts V and X of the local Companies Ordinance, and are in many respects based on the UK Companies Act 1929.[20] The detailed rules concerning procedures to be followed in liquidation are contained in the Companies (Winding-Up) Rules and the primary ground for winding-up is where the company in question is unable to pay its debts as they fall due. There is also the provision for an order to be made on other grounds, including that the order is 'just and equitable'. Where the order is made by the court, an official receiver becomes the provisional liquidator of the company. The liquidator is normally an insolvency practitioner and owes his or her duties to the court that made the appointment. In general, the law favours secured creditors who may realize their collateral without regard to the insolvency process. It is generally accepted in Hong Kong that a drawback of its corporate insolvency legislation is the lack of an effective procedure for rescuing companies during financial difficulties.[21]

In the aftermath of the Asian financial crisis of 1997/98, the Hong Kong Association of Banks (HKAB) issued guidelines on corporate workouts, closely modelled on the 'London Approach'. The Hong Kong Monetary Authority collaborated with the HKAB and formulated a revised set of principles in 1999, entitled the 'Hong Kong Approach to Corporate Difficulties'.[22] Like the London Approach, the Hong Kong guidelines are non-statutory and lack the support of an enforceable moratorium.

Attempts were made by the government in the late 1990s and early 2000s to introduce legislation relating to corporate rescue. The Law Reform Commission (LRC) of Hong Kong recommendations on corporate rescue were first published in October 1996 and emerged in the legislative form in the Companies (Amendment) Bill 2000, as a proposed new Part IVB (Provisional Supervision and Voluntary Arrangements) of the Companies Ordinance. The LRC favoured the appointment of a 'provisional supervisor' (a qualified insolvency specialist) to take over the running of the company whilst formulating a proposal for a 'voluntary arrangement' to be put to the company's creditors. However, the provisions met with criticism, and the Hong Kong Legislative Council Bills Committee decided in June 2000 that

20 C. Booth, 'Hong Kong Insolvency Law Reform: Preparing for the Next Millennium' (March 2001) *Journal of Business Law* 126.

21 B. Hsu, D. Arner, K.S. Tse and S. Johnstone, *Financial Markets in Hong Kong: Law and Practice* (Oxford University Press: Oxford, 2006) 52–3.

22 D. Carse, 'Hong Kong Approach to Corporate Difficulties' (February 2000) *Quarterly Bulletin* 70, available at http://www.info.gov.hk/hkma/eng/public/qb200002/toc.htm.

they needed to be reconsidered. Some of the flaws associated with the original Corporate Rescue Bill, include issues such as the disappointing treatment of workers' wages, complete exclusion of shareholders from the provisional supervision process, and the difficulty in classification of creditors.[23] As a result, the attempt to reform the law on corporate rescue in the early 2000s failed due to many political and economic factors and, to this day, Hong Kong does not have an effective mechanism for corporate rescue.

At present, the statutory regime for corporate rescue is the so-called 'scheme of arrangement' provided under section 166 of the Companies Ordinance and this section is inadequate in dealing with the complex corporate world that we now live in.[24] The advantage of such a scheme is that notwithstanding the fact that there may be a dissenting minority, a compromise or arrangement can still be effected in the manner contemplated by the Ordinance (three-quarters in value of creditors or members) and this shall be binding on all creditors, members or classes of creditors or members as the case may be. Absent such a statutory regime, a compromise or arrangement would require 100 per cent approval of affected creditors or members, which in the case of insolvency would enable a single creditor or member to defeat a scheme which reasonable and honest investors would otherwise accept.[25] The aim of the section 166 scheme is that creditors or members of a company can get a better financial return than would otherwise be so in the event that the company goes into liquidation.

A scheme of arrangement under section 166 is often a complicated exercise where even the simplest non-contentious scheme is unlikely to be formulated and sanctioned within three months. Moreover, the legal and other professional costs incurred would also be substantial and this often deters parties from formulating a scheme. Another disadvantage of section 166 is that there is a 'lack of moratorium'. Companies liable to be wound up may agree to an arrangement with their creditors in a non-statutory manner or pursuant to section 166 of the Companies Ordinance. However, the section does not protect the company from its creditors' actions to wind up the company, which may terminate an arrangement being formulated. In fact this deficiency has been summarized by the LRC itself when it attempted to introduce the Companies (Corporate Rescue) Bill back in 2001.

Under the present regime, it is common practice for ailing companies to appoint provisional liquidators in order to obtain a *de facto*

23 For details regarding criticisms of the Companies (Amendment) Bill 2000, see e.g. the article by P. Smart and C. Booth, 'Reforming Corporate Rescue Procedures in Hong Kong' (December 2001) *Journal of Corporate Law Studies* 485.

24 P.M. Kaye, 'Corporate Rescue and Hong Kong's Statutory Limitations' (2009) *Hong Kong Lawyer*, available at http://www.hk-lawyer.com/InnerPages_features/0/351/2009/1.

25 *Re Wah Nam Group Ltd (No. 2)* [2003] 1 HKLRD 282.

moratorium. The power to appoint liquidators is contained in section 193 of the Companies Ordinance and this is summarized in numerous decided cases. In *Re Legend International Resorts Ltd,*[26] the Hon. Mr Rogers V-P of the Hong Kong Court of Appeal held that the primary object of appointing a provisional liquidator is to maintain the status quo and to prevent anybody from obtaining priority over other creditors. However, the question then becomes whether a provisional liquidator can be appointed solely for the purpose of corporate rescue? According to case law, there is no 'jurisprudential objection' in extending the powers of provisional liquidators to carry out a corporate rescue role.[27] Yet it added that this 'extra power' only exists if the purpose of winding-up is fulfilled.[28] This means that under the current rule an appointment of provisional liquidator cannot be made for the 'sole purpose' of corporate rescue. Therefore, this has imposed considerable limitations on appointing provisional liquidators for the purpose of corporate rescue under the section 166 scheme of arrangement.

The present regime for corporate rescue in Hong Kong is more of a 'back-door' way of rescuing distressed companies by provisional liquidation masquerading as proper corporate restructuring by employing section 166 of the Companies Ordinance. Even the Hon. Mr Rogers V-P pointed out, in *Re Legend International Resorts Ltd*, that the existing regime for corporate restructuring under section 166 has its own deficiencies and limitations.[29]

In the aftermath of the global financial crisis 2008, the Hong Kong Government has decided to take an active role to reform its corporate rescue law. In October 2009, the FSTB of the Hong Kong Government published a consultation paper entitled *Review of Corporate Rescue Procedure Legislative Proposals*, with the aim of reforming key issues relating to corporate rescue. Accordingly, its aim is to respond to the recent global financial crisis and to reconsider the introduction of a corporate rescue procedure to facilitate companies with viable long-term business prospects, but in short-term financial difficulty, to turn around or restructure.[30] The proposal admits that each of the current options on corporate rescue has its own drawbacks and that there is a need to introduce a corporate rescue procedure to bridge the gap.

Despite the failed attempt to pass the Companies (Corporate Rescue) Bill 2001, the government believes that the most beneficial and expedient approach is to make use of the 2001 Bill as the basis for review and to consider the introduction of 'provisional supervision' as

26 [2006] 2 HKLRD 192.
27 *Re Keview Technology (BVI) Ltd* [2002] 2 HKLRD 290.
28 *Re Luen Cheong Tai International Holdings Ltd* [2002] 3 HKLRD 610.
29 Above n. 26.
30 Financial Services and Treasury Bureau, *Review of Corporate Rescue Procedure Legislative Proposals: Consultation Paper* (October 2009) 2.

a corporate rescue procedure.[31] Under the original 2001 Bill, the government proposed that the company or its directors or provisional liquidators may initiate provisional supervision by appointing a provisional supervisor. The provisional supervisor would be selected from a panel of practitioners comprising mainly solicitors and accountants. Accordingly, the provisional supervisor would manage and control the company, acting as the agent of the company when exercising its powers. He or she could retain or dismiss directors of the company, make alternative arrangements for any creditor and exclude some creditors from the moratorium.[32]

In its first Report on Corporate Rescue and Insolvent Trading which was recommended in 1996, the LRC did consider whether a regime similar to Chapter 11 of the US Bankruptcy Code could be adopted in Hong Kong. However, it concluded that the concept of DIP would not be acceptable to creditors in Hong Kong. There were concerns that if the existing management was allowed to remain in control, a company could easily avoid or delay its obligations to creditors. Further, it argued that a regime similar to Chapter 11 requires heavy court involvement which is costly and time-consuming.[33] As a result, the provisional supervision model was opted for in the 2001 Bill and it appears that this remains as the preferred model for the current proposal.

The issue as to who should manage the company during debt-restructuring is highly controversial. The LRC recommended that provisional supervisors should only be selected from a panel comprising solicitors and professional accountants.[34] The rationale for this is to ensure the quality of provisional supervisors. From the above discussion, one can see that the reform proposed in Hong Kong by the FSTB is very different from the DIP concept of Chapter 11 in the US. In the following section, this paper seeks to identify these differences from a law and economics perspective, and ultimately argue that it is impractical for Hong Kong to adopt the DIP concept similar to the US.

IV. Analysis and Discussion

In order to understand the corporate rescue law of a jurisdiction, one must also recognize the economic nature and historical development of that society. In the US, it is widely believed that there is a different attitude towards risk and risk-takers. According to a leading empirical study by two prominent US bankruptcy lawyers and a sociologist as mentioned earlier in this paper, bankruptcy debtors are not outliers in

31 *Ibid*.
32 For full details of the role and function of the provisional supervisor, refer to the government proposals above n. 30 at chs. 2 and 5.
33 Above n. 30 at 7.
34 *Ibid*.

society but people we know.[35] They are students, neighbours and associates who are victims of the US market-driven, highly competitive, compulsively consuming and anti-welfarist environment.

The origin of the US corporate restructuring system dates back to the railroad reorganization in the late nineteenth century. The miscalculation of the trans-national railway construction at the time led to massive corporate failures leaving long miles of incomplete railtracks. The federal government had to find a solution as the public need for an efficient railway system was rising. In response to the crisis, the Railroad Equity Receivership was developed which allowed reorganizations of many railway companies. The debtor-in-possession concept was memorialized with the first voluntary equity receivership, *Wabash, St. Louis and Pacific Railway*, the most celebrated case in the evolution of equity receiverships.[36] Courts reacted to the necessity of preserving the value of going concern and serving the public interest. This radical reform gave birth to novel ideas that became the genesis of business reorganization law adopted as part of the Bankruptcy Reform Act 1978.

In other words, the US economy diverged from the others, becoming much more capitalistic. This was done both out of necessity and design, as was illustrated in the railway example. The idea was to create a competitive economy quickly and also to survive harsh conditions in the new world.[37] Debt forgiveness, both personal and business debt, ultimately was seen as critical to a vibrant American economy. These historical and economic factors explain in large part why the US business bankruptcy system is more forgiving towards the debtor than other jurisdictions are. However, the same analogy may not apply to the concept of corporate rescue in Hong Kong because the stakeholders which reform proposal in Hong Kong is most concerned with are different from Chapter 11 in the US.

The US corporate rescue law is often said to be pro-debtor[38] for a number of reasons which this paper has mentioned earlier, such as easy access to Chapter 11 DIP, automatic stay, and that creditors can be 'crammed down'. Yet in Hong Kong, the objectives for provisional supervision in corporate rescue are radically different. Under paragraph 1.13 of the FSTB reform proposal, employees should generally be no worse off than in the case of insolvent liquidation and that consideration should be given to allow greater involvement of creditors in the rescue process in exchange for their being bound by the moratorium once the process commences and the rescue plan is

35 Above n. 9.

36 A. Martin, 'Railroads and the Equity Receivership: An Essay on Institutional Change' (1974) *Journal of Economic History* 685 at 697–701.

37 E.J. Balleisen, *Navigating Failure: Bankruptcy and Commercial Society in Antebellum America* (The University of North Carolina Press: Chapel Hill, NC, 2001).

38 R. La Porta, F. Lopez-De-Silanes, A. Shleifer and R. Vishny, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113.

agreed.[39] Further, the proposal stresses that it would be beneficial to the company's shareholders and creditors who might in due course get a better return from the success of the rescue plan than from the outcome of a winding up. It would be beneficial to the company's employees as well as suppliers and contractors for that portion of employment and purchases that might be retained by the rescue.[40] Recall that the previous attempt to introduce a corporate rescue law failed in Hong Kong because of the disappointing treatment of workers' wages, complete exclusion of shareholders from the provisional supervision process, and the difficulty in classification of creditors. Therefore, if a law is to be successfully promulgated this time, greater consideration would need to be given to these stakeholders.

Indeed the Hong Kong Institute of Certified Public Accountants (HKICPA) submitted its response to the corporate rescue proposals in February 2010, and it urged for a greater protection of employees' interest in the rescue process by proposing a partial upfront payment to employees on the ground that troubled companies cannot realistically compensate workers in full before a rescue proposal has been put in place.[41]

Perhaps the most influential stakeholder group which this reform proposal needs to accommodate is secured creditors. In fact in the original 2001 Bill the government proposed that the rights of all secured creditors may not be affected by the voluntary arrangement except with their consent. In its 2009 reform proposal, the government reiterates this and justifies its stance of protecting secured creditors' rights on the ground that such rights have also been well-protected in comparable jurisdictions like the UK and Australia.[42] This view is also supported by professional bodies such as the HKICPA in its response to the consultation.[43] This approach adopted by the government is understandable given the fact that many major secured creditors are financial institutions such as major banks and their influence both politically and economically cannot be ignored given that the growth of Hong Kong as a financial services hub has been supported largely by the banking sector.[44]

The Hong Kong FSTB admits at the outset in its consultation paper on the proposals for corporate rescue that the proposed procedures are creditor-oriented,[45] whereas US Chapter 11 is less creditor

39 Above n. 30 at 10.
40 *Ibid*. at 9, para. 1.11.
41 See HKICPA Press Release on 9 February 2010.
42 Above n. 30 at 36–7.
43 See HKICPA's response to Question 18 of the Consultation Paper, *Review of Corporate Rescue Procedure Legislative Proposals*, published on 4 February 2010.
44 Above n. 23 at 7.
45 Above n. 30 at 37, para. 7.6.

friendly, as discussed previously in this paper.[46] This difference is in line with the legal creditor rights ratings of the two jurisdictions as reported in a financial economics study in which a creditor rights index is developed for 129 countries and jurisdictions. This index ranges from 0 to 4 (with higher scores representing better creditor rights) and measures four powers of secured lenders in bankruptcy. Hong Kong (and also the UK) has a perfect score of 4, but the US has a score of 1.[47]

Moreover, in the US there is a dispersed pattern of share-ownership coupled with DIP reorganization law and theory. By the early 1960s, market-driven corporate governance in the US through takeover bids rather than concentrated shareholding had become a standard feature of the corporate scene. According to research conducted at the turn of the millennium, the so-called 'Berle & Means' corporations, where there is a separation of ownership and control, have largely become the phenomenon in the US.[48] This trend was accompanied by a shift in bankruptcy law towards a more flexible, manager-oriented regime, assuming that managers of corporations that have filed Chapter 11 will subsequently make business decisions in the best interests of the corporations as a whole. On the bankruptcy side these developments culminated in 1978 with the enactment of the Bankruptcy Code and its DIP norm.[49] However, in Hong Kong, the Berle & Means type of corporation is not as prevalent. According to research on ownership structures and control in East Asian corporations,[50] about three-quarters of the largest 20 companies in Hong Kong are under family control, while fewer than 60 per cent of the smallest 50 companies are in the same category. As for corporate assets held by the largest 15 families as a percentage of GDP, Hong Kong displays one of the largest concentrations of control, at 76 per cent. For comparison, the wealth of the 15 richest American families stands at about 3 per cent of GDP.[51]

Much of this research suggests that Hong Kong is a bit of a 'problem child' when it comes to dispersion of share-ownership and control of corporations. According to La Porta *et al.*,[52] ownership

46 G. McCormack, 'Apples and Oranges? Corporate Rescue and Functional Convergence in the US and UK' (2009) 18 *International Insolvency Review* 109 at 124.

47 S. Djankov, C. McLeish and A. Shleifer, 'Private Credit in 129 Countries' (2007) 84 *Journal of Financial Economics* 299 at 302.

48 R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'Corporate Ownership around the World' (1999) 54(2) *Journal of Finance* 471 at 509–11; 'Berle & Means' corporations are discussed in A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (Macmillan: New York, 1932).

49 J. Armour, B.R. Cheffins and D.A. Skeel Jr., 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom' (2002) 55 *Vanderbilt Law Review* 1699.

50 S. Claessens, S. Djankov and L.H.P. Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 *Journal of Financial Economics* 81.

51 *Ibid.* at 108–9.

52 Above n. 38.

dispersion and separation of ownership and control tend to be greater in rich common law jurisdictions where there is good legal protection of minority shareholders. Yet Hong Kong seems to be an anomaly of this generalization possibly due to its cultural background. Given such context, a corporate rescue process based on the DIP concept of the US will not be practical for Hong Kong because wide dispersion of share-ownership and manager-displacing corporate reorganization simply do not exist in reality. This is consistent with the government's proposal in rejecting the DIP given concerns that if the existing management was allowed to remain in control, a company could easily avoid or delay its obligations to creditors as the managers of a family business either are family members or are nominated by the family. They are expected to place the family's interests in the corporation as the first priority even at the expense of creditors' interests.[53] One possible way that may pose threats to the assets of an ailing corporation is tunnelling of the corporate assets by the controlling shareholders or the managers.[54] The government therefore recommended the appointment of an independent provisional supervisor to take effective control of the company during the period and to formulate a voluntary arrangement proposal for creditors within a timeframe.[55] Likewise the provisional supervisor would manage and control the company, acting as the agent of the company, and he or she could retain or dismiss directors of the company. Presumably the underlying rationale of this is to strengthen creditors or other stakeholders' commitment to the rescue process.

Also, since the early 1980s, DIP financing gradually became a well-established feature in the US and even an attractive line of business for lenders offering higher or more favourable interest rates on loans as well as various transactional fees and ancillary benefits.[56] Yet in contrast, the debt market is not as developed and is materially underused in Hong Kong. The major reason for illiquidity and lack of use is best expressed as Hong Kong's cultural background. Hong Kong lacks no resources for deal structuring but has no tradition of traded debt, and corporate governance practice has historically been insufficient to support issue of debts by large companies.[57]

Furthermore, the success of Chapter 11 rescue in small and medium enterprises has also been in doubt in the US. During the

53 A. Hargovan, 'Shareholders as Creditors in Hong Kong Corporate Insolvency: Myth or Reality?' (2008) 38 *Hong Kong Law Journal* 685. (The author suggests that 'the concentrated ownership of shares in Hong Kong companies, controlled by a dominant shareholder, has significant implications for attitudes to corporate rescue practice'. However, the author does not explain what kinds of attitudes he is referring to.)

54 S. Djankov, O. Hart, C. McLeish and A. Shleifer, 'Debt Enforcement Around the World', *Working paper of the World Bank and Harvard University* (2008) 11.

55 Above n. 30 at 7, para. 1.6.

56 J. White, 'Death and Resurrection of Secured Credit' (2004) 12 *American Bankruptcy Institute Law Review* 139.

57 Above n. 21 at 10–11.

1990s, a number of scholars in the US conducted studies as to whether Chapter 11 saves economically inefficient firms. Two surveys of small and medium-sized enterprises (SMEs) in Chapter 11 find that only one-sixth to one-quarter succeed in adopting a reorganization plan and remain in operation.[58] Two other surveys of large public companies in Chapter 11 find that although these companies are very likely to adopt reorganization plans, about a third of them either file under Chapter 11 a second time or undergo a private restructuring within a few years after emerging from Chapter 11 protection.[59]

Chapter 11 is a long drawn-out complex process with many court hearings and its use in small business cases has long been criticized as being too cumbersome, expensive and slow.[60] Given that Chapter 11 adopts a 'one size fits all' approach towards corporate reorganization, small businesses are required to follow the same reorganizational steps as large conglomerates. This did not seem to produce efficient results and many small business cases failed, where they are merely converted to Chapter 7 of the US Bankruptcy Code to liquidation.[61]

In proposing reform for corporate rescue in Hong Kong, the FSTB seems to have been mindful of SMEs' participation and cited heavy court involvement, cost and time as part of the reasons for rejecting a regime similar to Chapter 11.[62] It therefore suggests that provisional supervision is likely to improve the chances of more rescues being attempted and would encourage directors to seek help on a more timely basis.[63]

V. Conclusion

This paper has examined the corporate rescue reform proposed by the Hong Kong FSTB and how it differs from the DIP approach adopted by Chapter 11 of the US Bankruptcy Code. The reform proposal suggested by the FSTB is largely a repeat of the Companies (Corporate Rescue) Bill that was proposed in 2001 yet rejected by the then Legislative Council due to economic and political factors. The FSTB believes that the use of a provisional supervisor to manage the company during restructuring as laid down in the 2001 Bill should form the basis of the present reform due to its 'expediency'. This paper argues that the FSTB reform approach on corporate rescue differs from the DIP approach adopted by the US largely due to the

58 See e.g. S. Jensen-Cocklin, 'Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law' (1992) 97 *Commercial Law Journal* 297.
59 See e.g. L.M. LoPucki and W.C. Whitford, 'Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 78 *Cornell Law Review* 597.
60 G. McCormack, 'Rescuing Small Business: Designing an efficient legal regime' (2009) 4 *Journal of Business Law* 299 at 309.
61 *Ibid.* at 310.
62 Above n. 30, para. 1.6.
63 *Ibid.* para. 1.12.

law, and economic (and cultural) factors between the two jurisdictions. Hence the reform proposal in Hong Kong is simply a reflection of the corporate and commercial nature of its economy.

In his latest Budget Speech, John C. Tsang, the Financial Secretary of Hong Kong, has reiterated that one of its policy objectives is to consolidate Hong Kong as a major financial centre by modernizing the Companies Ordinance to enhance corporate governance and introduce a corporate rescue procedure in order to reduce corporate bankruptcy and preserve employment.[64]

On this issue, Hong Kong has an excellent opportunity to assert the pragmatism of its legal system. If Hong Kong is to safeguard its reputation as a major financial centre and a centre for professional commercial practice, this is just the kind of step it needs to take. At the time of writing, Hong Kong has been affected by the global financial crisis of 2008. However, economic downturn often provides opportunity for major reform. If Hong Kong wishes to maintain and foster quality business in a competitive global corporate environment and retain itself as the gateway to the Greater China market, the law that governs businesses must be transparent, coherent and consistently applied. The best way to meet these stated goals is by statutory intervention, allowing businesses the flexibility to make 'fresh starts' during financial difficulties as this would benefit major stakeholders. The opportunity was missed during the last recession of the early 2000s; it must make every endeavour not to repeat the same mistake this time round. Politicians and lawmakers have often promulgated their intent to make Hong Kong a 'paragon of corporate governance'. There is probably no better time than now to put this policy objective into action with the implementation of a clear and pragmatic statute on corporate rescue.

64 See Paragraph 79 of the Budget 2010–11, available at http://www.budget.gov.hk/2010/eng/budget23.html.