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***Should Hong Kong Reform its Insolvency Law in Times of
COVID-19?***

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Should Hong Kong Reform its Insolvency Law in Times of COVID-19?

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Introduction

With the onset of the COVID-19 pandemic, the number of insolvency filings by otherwise economically viable firms globally is expected to rise significantly. Hong Kong will not be an exception. Hong Kong does not currently propose to enact legislation to impose a universal standstill of contractual obligations in response to COVID-19, as is the case in other jurisdictions.¹ Once Hong Kong Monetary Authority's (HKMA's) measures for the banks to support the small and medium size enterprises (SMEs) and the Hong Kong Government's economic relief packages come to an end, an enormous wave of defaults will come.² SMEs are defined by the Hong Kong Government to mean enterprises (outside of manufacturing) with fewer than 50 employees or in the case of manufacturing, with fewer than 100 employees.³

The collapse of SMEs will have a serious impact in Hong Kong as SMEs account for 45% of the private sector total employment and 98% of all of the business establishments.⁴ The Hong Kong Government is proposing to enact legislative reforms to allow for provisional supervision and corporate rescue, which are out-of-court procedures, to facilitate restructuring if the major secured creditor consents. This proposal is not new; it first appeared in the recommendations of the Law Reform Commission⁵ has been attempted in 2000 and 2001, during the period immediately post-Asian financial crisis of 1997.⁶ Other previous consultations

¹ See e.g. Coronavirus Act 2020 (UK) has a moratorium for a limited period on forfeiture of commercial leases on the ground of non-payment rent by tenants, though it does not amount to a waiver of the rental obligations. In Singapore, on 7 April 2020, the COVID-19 (Temporary Provisions) Act was enacted as a "pause" button to restrict contractual parties from insisting contractual performance that is materially affected by COVID-19 and the legislation was further amended in June 2020 to mandate that landlords provide rental waiver for up to four months to tenants. Further relief is found in the Rental Relief Framework for SMEs, which mandate the renegotiation of rental obligations for businesses to recover from COVID-19, available at <https://www.mlaw.gov.sg/covid19-relief/rental-relief-framework-for-smes>.

² See e.g. Yiu, E, "Hong Kong resurrects Chapter 11-style corporate rescue bill after 24-year hiatus as Singapore powers ahead with reforms" SCMP (12 March 2020). Statistics from the Official Receivers' Office shows that the number of winding-up petitions against companies has increased 25% in Jan-May 2020 to 146 (compared to the same period in 2019), <https://www.oro.gov.hk/cgi-bin/oro/stat.cgi>.

³ Trade and Industry Department 2020, "Small and Medium Enterprises", available at https://www.tid.gov.hk/english/smes_industry/smes/smes_content.html.

⁴ Ibid.

⁵ Law Reform Commission 1996, *Report on Corporate Rescue and Insolvent Trading*, available at <https://www.hkreform.gov.hk/en/docs/rrescue-e.pdf>.

⁶ Financial Services and Treasury Bureau (FSTB), 2014, *Consultation conclusions of improving corporate insolvency law and detailed proposals for introducing new statutory corporate rescue procedure*, available at https://www.fstb.gov.hk/fsb/ppr/consult/doc/impccill_consult_conclusion_e.pdf.

took place in 2009/2010⁷ (*2010 Consultation Conclusions*), to address the economic fallout post-2008 global financial crisis, but did not lead to legislative change.⁸ As at the date of writing, the draft bill relating to the proposed provisional supervision and corporate rescue has not yet been published.

The proposed corporate rescue framework is long overdue. In recent years, many common law jurisdictions, including Singapore⁹ and the UK,¹⁰ have reconsidered and modernised their insolvency framework to include debtor-in-possession features in court-supervised restructurings that are based on Chapter 11 of the US Bankruptcy Code 1978 (Chapter 11). These features include an automatic moratorium or stay of proceedings and the ability to cram-down dissenting creditors not only within the same class but across classes of creditors.¹¹

Further, specifically in response to COVID-19, several jurisdictions have enacted or are in the process of enacting insolvency legislation that allows SMEs and small businesses to access the bankruptcy or restructuring provisions more speedily. For example, in Singapore, in October 2020, the Singapore Government introduces the Insolvency, Restructuring and Dissolution (Amendment) Act¹² which enable micro and small companies (defined as companies with annual revenue of less than \$1 million and \$10 million respectively) to access the process that will enable to restructure more cheaply and speedily. In the US, the Small Business Reorganizations Act and the Coronavirus Aid, Relief and Economic Security (CARES) Act allow smaller businesses access to less expensive and speedier bankruptcy processes in the courts.¹³

Reforms to Insolvency and Restructuring Laws in Hong Kong

The question is whether even if the provisional supervision and corporate rescue framework is enacted, should Hong Kong make other more far-reaching reforms, particularly to its court-supervised restructuring framework? Hong Kong's restructuring framework currently limits restructurings to consensual workouts and schemes of arrangement. Schemes of arrangement are the only court-supervised restructuring framework that is available in Hong Kong. This framework remains very much creditor-driven where creditors or the insolvency practitioners drive the outcomes of the restructuring. In fact, while Hong Kong ranks highly in

⁷ FSTB, 2010, *Review of corporate rescue procedure legislative proposals: Consultation conclusions*, available at https://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp_conclusions_e.pdf

⁸ FSTB, 2014, n 6, above.

⁹ Companies (Amendment) Act 2017 (Singapore).

¹⁰ Corporate Insolvency and Governance Act 2020 (UK) (came into force on 26 June 2020).

¹¹ E.g. see McCormack, G & Wan, WY 2019, "Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's Restructuring and Insolvency Laws: Opportunities and Challenges" 18 JCLS 69.

¹² Ministry of Law, "Simplified Insolvency Programme", Press Release, 5 October 2020, available at <https://www.mlaw.gov.sg/news/press-releases/simplified-insolvency-programme>.

¹³ See generally, Skeel D, 2020 "Bankruptcy and the coronavirus", available at <https://www.brookings.edu/research/bankruptcy-and-the-coronavirus-part-ii/>

the World Bank's Doing Business 2020 (third overall), its score on resolving insolvency is the lowest among all its indicators (World Bank, 2020).¹⁴

While Hong Kong's restructuring regime has served it well through the Asian financial crisis of 1997 and the global financial crisis of 2008, it cannot be assumed that it will work through the COVID-19 crisis. The current regime faces three key limitations that were not present in the earlier crises.

First, the schemes of arrangement in Hong Kong, which is based on the English scheme framework, is geared towards restructuring of financial debt, similar to the English scheme.¹⁵ It is not geared towards restructuring of operating debt. Also, schemes of arrangement require applications to court on two occasions, one at the stage of convening the meeting, and the second at the stage of sanction, which can make the process quite costly. As the restructuring of SMEs tends to be less complex because SMEs have few unencumbered assets and are typically dominated by fewer secured creditors, the costs of restructuring via schemes of arrangement could be disproportionately high.

Second, there is no provision for automatic moratorium or stay of enforcement proceedings while the company undergoes a scheme of arrangement. The problem is partly ameliorated by Hong Kong practitioners having adapted by using the mechanism of provisional liquidation where the company is first put into winding up under the Companies (Winding Up and Miscellaneous Provisions) Ordinance.¹⁶ However, such an action may often be the death-knell for the company's businesses.

Third, in times of crises, fresh financing is often required. Unlike the earlier crises, there can be no expectation that SMEs or larger firms can access fresh financing. If there is any requirement to incentivize provision of financing, legislative reforms will be required as Hong Kong insolvency law does not provide for any special treatment of rescue financing. In the absence of such financing, the question remains as to whether there are sufficient incentives for lenders or other financiers to lend to businesses during this period. The problem is exacerbated for SMEs which have limited access to financing options, including trade credit, financing from banks and other lenders and the government-backed grants.

The issue of rescue financing is controversial. The US Bankruptcy Code allows for super-priority status and super-priority liens and US law and economics scholars have regarded super-priority financing, a prominent feature of Chapter 11, as being necessary for companies in distressed situations.¹⁷ Singapore has also reformed its insolvency legislation to allow for loans

¹⁴ Data obtained from World Bank Doing Business 2020,

<https://www.doingbusiness.org/en/data/exploreconomies/hong-kong-china#> (accessed 30 June 2020).

¹⁵ Payne, J, 2014, *Schemes of Arrangement: Theory, Structure and Operation* (CUP).

¹⁶ Cap 32. See generally, Qu, C 2012, "Towards an Effective Scheme-Based Corporate Rescue System for Hong Kong" 12 JCLS 85.

¹⁷ McCormack, G, 2007, "Super-priority new financing and corporate rescue" *Journal of Business Law* 701.

to be given super-priority status in certain circumstances.¹⁸ While the granting of super-priority status and super-priority liens may increase the costs of debt overall,¹⁹ the complete absence of such status will make it difficult for businesses to access such financing.

Considerations for reforms

This article proposes that urgent consideration be given to the following to simplify the insolvency and restructuring framework in Hong Kong. First, as more than 80% of Hong Kong's listed firms are incorporated outside of Hong Kong,²⁰ formal pre-insolvency restructuring parallel proceedings will be required at both jurisdictions, in Hong Kong and in the law of incorporation.²¹ This would inevitably drive up costs. It has been observed that in case law that such parallel proceedings is outmoded today and should be reformed.²²

Second, while the 2010 *FSTB Consultation Conclusions* rejected the debtor in possession framework found in Chapter 11 for Hong Kong's proposed corporate rescue framework, it left open a hybrid approach that allows existing management to be in place while the restructuring takes place. It is suggested that the issue be revisited, whether for corporate rescue or schemes of arrangement.²³ Scholars have traditionally argued that the presence of controlling shareholders results in a debtor in possession framework to be unsuitable for Hong Kong.²⁴ However, while controlling shareholders may exacerbate the creditors/shareholders conflict and resulting in creditors worse off, even when the company is out of money, more recent evidence shows that in jurisdictions whose shareholdings are concentrated, controlling shareholders are often instrumental to the success of restructuring.²⁵ Given that SMEs are managed by shareholders or owners, and may have every incentive to keep the company alive even past viability, safeguards need to be put in place, such as oversight from an insolvency practitioner.

Third, it is suggested that a special framework be enacted for the restructuring of SMEs to allow for the fast-tracking of approval of schemes, that will enable plans to be binding on dissenting minority of creditors within the same class. Such a framework can exist together with the proposed provisional supervision and corporate rescue, which is intended an out of court procedure, providing the choice for debtor companies.

¹⁸ McCormack & Wan, 2019, n 11 above.

¹⁹ Department for Business, Energy and Industrial Strategy (UK DBEIS, 2018), *Insolvency and Corporate Governance: Government Response*, available at [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG - Government response doc - 24 Aug clean version with Minister s photo and signature AC.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736163/ICG_-_Government_response_doc_-_24_Aug_clean_version_with_Minister_s_photo_and_signature_AC.pdf)

²⁰ Wan WY, C Chen and Goo SH, 2019, "Public and Private Enforcement of Corporate and Securities Laws: An Empirical Comparison of Hong Kong and Singapore" *European Business Organization Law Review* 319.

²¹ See for example, *Re Da Yu Financial Holdings Limited* [2019] HKCFI 2531.

²² *Ibid.*

²³ See Qu, C 2012, "Towards an Effective Scheme-Based Corporate Rescue System for Hong Kong" 12 *JCLS* 85.

²⁴ *Ibid.*

²⁵ Wan WY, C Watters and G McCormack, "Schemes of Arrangement in Singapore: Comparative and Empirical Analysis", (2020) 94 *American Bankruptcy Law Journal* 463.

Conclusion

COVID-19 raises unprecedented challenges for governments in determining appropriate legislative responses. Insolvency law and policy can be used as a tool to rescue firms in financial difficulties but which are otherwise economically viable. Given Hong Kong's decision not to enact a universal standstill for contractual relief, the need for intervention in insolvency law will assume greater importance. This article makes some suggestions in how such reforms can take place. Even if the reforms cannot be put in place for the current crisis, they would ensure that Hong Kong is more prepared for future economic crises.