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FORMS OF SECURITY

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

Immovable property

Common forms of security. The most common types of security for immovable property are:

- **Legal mortgage.** This transfers legal title to a debtor’s property to the creditor with a right to sell that property if the debtor defaults. Legal title must be returned to the debtor when the debt is paid.

- **Equitable mortgage.** This transfers the beneficial interest in a debtor’s property to the creditor. An equitable mortgage can arise if parties do not comply with the formalities necessary to create a legal mortgage (for example, if they do not execute a deed).

- **Fixed charge.** This is created where a debtor provides the creditor with an immediate proprietary interest in an asset but retains control of it. The asset’s ownership and possession are not transferred to the creditor, but the debtor cannot deal with the asset without the creditor’s consent. A fixed charge binds subsequent creditors. If the debtor defaults, the creditor can apply for a court order to sell the charged asset or appoint a receiver to take possession of it.

Formalities. Charges from companies incorporated or registered in Hong Kong must be registered with the Companies Registry within 35 days of creation. Registration applies to Hong Kong companies and foreign companies registered in Hong Kong. It does not apply to foreign companies not registered in Hong Kong, even if they have a place of business in Hong Kong.

Charges over land and buildings in Hong Kong must also be registered with the Land Registry within one month of creation to guarantee priority over subsequent charges. However, a document creating a floating charge over land cannot be registered until the charge has, by notice served on the chargor, crystallised. Charges over land and buildings not registered with the Land Registry are only void against a bona fide purchaser of mortgagee for valuable consideration. Therefore, an unregistered charge may still be enforceable against a donee or personal representative of the chargor.

Charges and mortgages over land and buildings must be created by deed.

Movable property

Common forms of security. The most common types of security for movable property are:

- **Legal and equitable mortgages.** See above, Immovable property. Legal mortgages must be created by deed.

- **Fixed charge.** See above, Immovable property. Charges with a power of attorney must be created by deed and, to avoid arguments over consideration, it is recommended that all third party charges (and preferably all charges) be executed as a deed.

- **Floating charge.** This is a charge over a class of assets (such as trading stock, current assets or bank accounts). A debtor can continue to deal with the assets in the ordinary course of business until the charge crystallises and the creditor takes steps to enforce it.

A floating charge crystallises, and changes into a fixed charge (see above, Movable property) if:

- a default specified in the charge document takes place. The creditor can then appoint a receiver to take control of the charged asset (see Question 4);
- the creditor exercises a right (commonly included in charge documents) to crystallise the floating charge immediately;
- circumstances arise which lead to automatic crystallisation (such as the debtor ceasing business).

- **Pledge.** The creditor has a right to possess the pledged asset and sell it to recover a debt. It is created by actual delivery of the asset to the creditor, who holds it until the

Effects of non-compliance. If a company incorporated or registered in Hong Kong fails to register a registrable charge at the Companies Registry within 35 days of creation, the charge will be rendered void against the liquidator and any creditor of the company. However, the charge remains enforceable between the parties and against a third party who later purchases the property subject to the charge from the company. The obligation to repay the money secured by the charge is not affected and is immediately enforceable.

If a charge over land and buildings is registered more than one month after the date of creation, the charge is not void, but the charge’s priority may be affected.

A charge or mortgage over land and buildings which is not created by deed may still take effect as an equitable charge or mortgage, provided the contract is in writing and signed by both parties. Otherwise the contract is not specifically enforceable, and does not create an equitable charge or mortgage over the land.
debt is settled. The debtor retains legal title to the pledged asset.

- **Lien.** This gives the creditor a right to retain, but not to sell, a debtor’s assets that are already in its possession (such as items to be repaired) until a debt has been paid. Since a lien is based on possession of the goods by the creditor, it terminates when the assets are returned to the debtor.

**Formalities.** Depending on the type of asset, the following formalities may apply:

- **Fixed charge.** Fixed and floating charges over most movable property of companies incorporated or registered in Hong Kong must be registered with the Companies Registry within 35 days of creation. Registration applies to both Hong Kong companies and foreign companies registered in Hong Kong (see above, Immovable Property).

- **Floating charge.** See above, Fixed charge.

- **Mortgage over ships.** This must also be entered in the Shipping Register. The mortgage instrument must:
  - be in the specified form;
  - set out the name and address of each mortgagee and mortgagor (among other things); and
  - be duly executed by or on behalf of each mortgagor in the specified manner.

If two or more mortgages have been registered in respect of the same ship, priority among the mortgagees is determined by reference to the order of registration of the mortgages, irrespective of the date they were made or executed.

- **Mortgage over aircraft.** This can be registered with the Civil Aviation Department, but there are no specific legal requirements for registration of aircraft mortgages in Hong Kong. Where (unusually) the mortgagor is an individual person, the mortgage could be registrable as a bill of sale. Where the mortgagor is a company, see above, Fixed charge.

- **Mortgage over personal chattels.** A written mortgage over most personal chattels in Hong Kong is considered a bill of sale. The mortgage must be in the statutory form, duly attested and registered with the Registrar of the High Court within seven clear days after its execution.

**Effects of non-compliance.** If a company fails to register a registrable charge over movable property at the Companies Registry, the charge will be void against the liquidator and any company creditor (see above, Immovable Property).

An un regist ered legal mortgage of a ship remains valid. If there is no legal mortgage and the registration formalities have not been observed, the mortgage may still be valid as an equitable mortgage.

A written mortgage over personal chattels in Hong Kong is void if it is not duly attested and registered with the Registrar of the High Court within seven days after execution in respect of the chattels comprised therein.

A legal mortgage or charge which is not created by deed may still take effect as an equitable mortgage.

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**CREDITOR AND SHAREHOLDER RANKING**

2. Where do creditors and shareholders rank on a company’s insolvency?

The term bankruptcy refers to personal insolvency and liquidation refers to corporate insolvency.

The ranking of creditors partly depends on the circumstances of each case. However, the general order of priority is:

- **Secured creditors.** Debts secured by a mortgage or a fixed charge (see Question 1, Immovable property) are paid (less the costs of realisation) from the sale proceeds of the charged assets. Equitable mortgages rank behind legal mortgages, and fixed charges over the same asset rank in the order of creation.

- **Liquidation costs.** These include the liquidator’s fees, the costs of winding-up petitions and realisation costs.

- **Preferential creditors.** Employees can, for example, claim some amounts owed to them, such as wages and holiday pay. The same rule applies to insurance and reinsurance claims for businesses in Hong Kong.

- **Floating charge holders.** See Question 1, Immovable property. These are only paid from the sale proceeds of a floating charge if all preferential creditors have been paid in full. Floating charges over the same asset rank in order of creation. If the sale proceeds are not sufficient to pay the debt, the creditor can claim the balance as an unsecured creditor.

- **Unsecured creditors.** Any surplus remaining after the floating charge holders have been paid in full is distributed to other creditors.

Unsecured creditors rank equally for payment, and are paid on a proportional basis if there are insufficient assets to meet their claims in full.

- **Shareholders.** Any remaining assets are used to repay the shareholders’ capital contributions.

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**UNPAID DEBTS AND RECOVERY**

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

Trade creditors can use the following mechanisms to secure unpaid debts:

- **Lien.** See Question 1, Movable property.

- **Retention of title clause (Romalpa clause).** This is often included in a supply agreement and allows the creditor to retain title to goods until the debtor has both:
  - fully paid for the goods;
  - fully repaid all outstanding sums.

If payment is not made, the creditor can recover the goods from the debtor. The right to title is lost if the goods are:

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

Procedures to recover debt

An unsecured creditor can begin legal proceedings to recover its debt. A creditor can seek a freezing order (Mareva injunction) over the debtor's assets (up to the amount claimed) until a formal hearing takes place, if it can satisfy the court that there is both a:

- Real danger of the debtor dissipating its assets.
- Good arguable case with a substantitive claim.

Most security documents allow a receiver to be appointed if a default occurs or the debtor does not make payment as agreed. A receiver can usually take possession of specific assets belonging to the debtor. The receiver can choose to safeguard these assets, or to receive income from or dispose of them. Court approval is not required to appoint a receiver, but the appointment can be challenged in court (for example, if security is not validly taken). The court can also appoint a receiver under a charging order in debt recovery actions or to safeguard disputed property. The order appointing the receiver sets out his powers.

A receiver must realise the company's assets and pay the debt owed to the party who appointed him. If he is appointed under the terms of a floating charge, his appointment is likely to coincide with the crystallisation of the charge. Before paying the debt owed to the charge holder, the receiver must first pay any preferential creditors (see Question 2).

The appointment of a receiver often leads to the company's liquidation.

Mandatory set-off of mutual debts

The following conditions must be satisfied for a set-off to apply on a company's insolvency:

- There must be credits, debts or other dealings between the insolvent company and creditor.
- The credits, debts or other dealings must be mutual, so they must be between the same persons and in the same right.
- The claims must be provable in the winding up.

However, a creditor cannot claim the benefit of any set-off if he had, at the time of giving credit to the debtor, notice that the petition had been presented. The effective date at which the mutual claims must exist is the date of the winding up order. Therefore, provided that the mutual claims or a contingent liability existed at the date of the winding up order, the set-off can apply when the claim is brought or contingency is fulfilled at a later date. Generally, the rules on set-off on insolvency are mandatory and it is not possible to contract out of them.

STATE SUPPORT

5. Is state support for distressed businesses available?

The government is concerned about the difficulties faced by small and medium-sized enterprises (SMEs). The Trade and Industry Department (TID) provides SMEs with free business information and practical consultation services, including offering advice to deal with business operation problems. The TID operates a SME Loan Guarantee Scheme which aims to help SMEs to secure loans of up to HK$12 million (as at 1 March 2012, US$1 was about HK$7.8) for each enterprise, from participating lending institutions to:

- Acquire business installations and equipment.
- Meet working capital needs.

The government guarantees 50% of approved loans, subject to a maximum of HK$6 million. All SMEs with substantive business operations in Hong Kong and registered in Hong Kong under the Business Registration Ordinance can apply.

The TID also introduced a time-limited special loan guarantee scheme in December 2008 which aims to help Hong Kong enterprises to secure loans of up to HK$12 million for each enterprise to meet general business needs during the global financial crisis, with the government guaranteeing up to 80% of approved loans. All companies with substantive business operations in Hong Kong and registered in Hong Kong under the Business Registration Ordinance can apply, except for listed companies and lending institutions (and their associates).

Although banks' lending policies are generally at their commercial discretion, the Hong Kong Monetary Authority (HKMA) and the Hong Kong Association of Banks jointly published The Hong Kong Approach to Corporate Difficulties in 1999. This sets out formal (but non-statutory) guidelines (Guidelines) on how institutions should deal with corporate borrowers in financial difficulties where the borrower is dealing with multiple banks. The Guidelines ask banks not to withdraw facilities at the first sign of trouble. Instead, they are advised to work together to ensure the company continues to trade while a considered view of its prospects can be reached.

The HKMA adopted a series of measures to alleviate the difficulties facing businesses during the global financial crisis. This included issuing circulars to all banks, strongly suggesting that they:

- Continue to support their SME customers.
- Be accommodating and flexible in relation to the funding needs of SMEs.
- Refrain from hasty and indiscriminate withdrawal or reduction of credit lines.

They were also reminded to follow The Hong Kong Approach to Corporate Difficulties.
Workout

Objective. A workout is a contractual arrangement or compromise between a company and all its creditors, which aims to prevent liquidation and enable the company to rescue its business.

Initiation. A company can negotiate with its creditors at any time before liquidation proceedings begin. The process is voluntary and there is no obligation on the company or its creditors to enter into negotiations for a workout. The courts are not involved and success depends on reaching an agreement. As there is no moratorium, dissenting creditors can go against the wishes of the majority of creditors and begin insolvency proceedings. Any company can make a workout arrangement.

Substantive tests. There is no substantive test that a company must meet before it can negotiate a workout.

Supervision and control. The creditors can nominate a lead creditor to head the negotiations with the company. The company’s existing management remains in place during the period of negotiation with the creditors.

Protection from creditors. During the period of negotiation with its creditors, there is no moratorium to prevent creditors from enforcing their claims.

Length of procedure. There is no required time frame in which the parties must agree the terms of a workout. As there is no moratorium, a quick conclusion is advisable. However, the process often takes months or years.

Conclusion. The company and all its creditors must unanimously approve the terms of a workout. The procedure concludes when the parties sign the workout arrangement and implement its terms. Once a workout is agreed, creditors often monitor its implementation through a committee of creditors.

Since the aim of a workout is to prevent the company from going into liquidation, the company will normally continue to exist. However, the creditors are free to begin liquidation proceedings if any standstill arrangement expires or is terminated.

Scheme of arrangement

Objective. A scheme of arrangement (section 166, Companies Ordinance (Cap. 32), Laws of Hong Kong) is a binding arrangement between the company and its creditors or shareholders, which aims to prevent the company’s liquidation. The court must approve a scheme of arrangement.

Initiation. The company, its creditors or its shareholders can begin negotiations for a scheme at any time, although there is no obligation on any party to do so. A scheme of arrangement can be made in relation to any company registered in Hong Kong, including overseas companies registered under Part XI of the Companies Ordinance.

Substantive tests. There is no substantive test that the company and its creditors or shareholders must meet. It is not necessary for a company to show that it is unable or likely to become unable to pay its debts. Solvent companies in group reorganisations, mergers and demergers often use schemes of arrangement.

Supervision and control. The scheme of arrangement is substantially supervised by the court. Once a proposal has been formulated by the company, it must obtain the court’s approval to call the meetings of the respective classes of creditors and shareholders. If approval is obtained, the meetings are called. The scheme must be approved by at least 75% in value and 50% in number of the classes of creditors or shareholders voting at their respective meetings. If the creditors and shareholders approve the proposal at the meetings, an application must then be made to the court to sanction the scheme. The court’s approval is required to ensure fairness. If creditor approval is unanimous,
the court will be reluctant to reject a scheme. The company's existing management remains in place throughout the process.

**Protection from creditors.** Initiation of the scheme of arrangement does not trigger a moratorium on creditor claims. As there is no moratorium, any dissenting creditor can begin liquidation proceedings against the company, which prevents a scheme from being concluded. To mitigate this, a scheme is sometimes prepared together with a provisional liquidation.

**Length of procedure.** Concluding schemes of arrangement can take more than a year, and be expensive because of the court's involvement and the need to define carefully the classes of creditor to which the scheme applies. There is no prescribed form for a scheme of arrangement, but it must be clearly explained to creditors through a separate document called an explanatory statement.

**Conclusion.** Once approved, the scheme is binding on the company and all creditors or shareholders. Under the terms of the scheme, an administrator (who is usually an insolvency accountant) is appointed to implement the arrangement.

A scheme generally concludes when its terms have been implemented. There are usually provisions relating to:
- Early termination (for example, through a creditors' vote).
- Payment of final dividends.
- Final arrangements on conclusion of the scheme.

Since the purpose of an insolvent company entering into a scheme of arrangement is usually to avoid compulsory liquidation, the company normally continues to exist.

**Compulsory liquidation**

**Objective.** The aim of compulsory liquidation is to realise a company's assets and distribute them to creditors in order of priority (see Question 2).

**Initiation.** A winding-up petition must be presented to the court by any of the following parties:
- The company.
- The company's directors.
- The company's creditors.
- Certain government officials.

There is no obligation on any party to present a winding-up petition. Most compulsory liquidations are begun by unpaid creditors, or by creditors who have served a statutory demand and not received payment within 21 days.

After a petition is presented, if there is evidence that a company's affairs are being dissipated, the court can appoint a provisional liquidator to protect these assets. The appointment usually continues until the court has dealt with the petition. It is also common for the court to appoint provisional liquidators (whenever necessary), to maintain a company's existing position until a rescue plan is arranged.

Any company can be compulsorily liquidated (whether registered in Hong Kong or elsewhere), provided it is connected with the jurisdiction.

**Substantive tests.** A petition must state at least one of six grounds. The most common are:
- The company is unable to pay its debts. This is presumed if the company fails to satisfy a debt of a specified minimum amount (as at 1 March 2012, HK$10,000 (about US$1,282)) within 21 days of a statutory demand, or if a judgment debt is not satisfied in whole or in part. In these circumstances, a creditor does not need to prove insolvency (proof of insolvency is a separate ground).
- A special resolution for liquidation has been passed by at least 75% of shareholders' votes cast.
- It is just and equitable to liquidate the company.

**Supervision and control.** Between the time when the winding up petition is presented and a winding up order is made, a provisional liquidator can be appointed to protect the company's assets. The provisional liquidator's appointment continues after the winding up order is made, until that person becomes the liquidator or another person is appointed. If no provisional liquidator is appointed, the Official Receiver becomes the provisional liquidator until he, or another person, is appointed liquidator.

After the winding up order is made, the provisional liquidator must convene separate meetings of the creditors and contributories within three months. At these meetings, a liquidator is appointed by the creditors to take control of the company and the directors' powers cease.

**Protection from creditors.** The court has the power to stay or restrain proceedings against the company after presentation of the winding up petition, but before a winding up order has been made. When a winding up order is made, the winding up is deemed to have commenced at the time of the presentation of the petition and there is an automatic stay on any actions proceeded with or commenced against the company (unless the court consents to the claims). The court rarely gives consent and the company's affairs are resolved using the rules applicable to liquidation. A liquidator investigates the conduct of the company's affairs, with a view to maximising the return to creditors.

**Length of procedure.** After the presentation of a winding up petition, it is likely to be several months before the winding up order is made. The meetings with creditors and contributories will often take a further two months. Therefore, the entire process can take at least six to eight months to complete.

**Conclusion.** Once the liquidator is appointed, there is a moratorium on proceedings against the company, unless the court consents to claims (see above, Protection from creditors).

A creditors' committee (committee of inspection), which usually comprises between two and five creditors or their representatives, is usually appointed at the first creditors' meeting, and supervises the liquidator. In particular, it must approve agreements with creditors and the conduct of proceedings by or against the company. Each creditor must file a proof of debt to claim in the liquidation, which the liquidator considers on its merits. Creditors can appeal against the liquidator's rejection of their claim within 21 days of being notified of this.

The court can order liquidations for assets worth less than HK$200,000 (about US$25,641) to be conducted summarily, in which case the first creditors' meeting is not held.
If there is a large number of creditors, the court can order the liquidation to be conducted under a regulating order. This is where the court rather than the creditors appoint the liquidator and/or the inspection committee.

It is possible to convert a compulsory liquidation to a creditors’ voluntary liquidation (see below, Creditors’ voluntary liquidation) with the court’s approval.

When the liquidation is complete and the assets have been distributed, the liquidator can apply to the court for his release. Prior notice of the application should be given to all creditors with a summary of all receipts and payments in the liquidation.

When the court has granted a release to the liquidator, a notice of this is published in the Government Gazette. On application from the liquidator, the court orders the company to be dissolved when the proceedings are complete. The liquidator must send a copy of this order to the Companies Registry within 14 days. Dissolution brings the company to an end.

Creditors’ voluntary liquidation

Objective. The aim of a creditors’ voluntary liquidation is to wind up a company without involving the court.

Initiation. A company’s directors can begin the procedure if they believe that there is no real prospect of the company paying its debts. The directors convene an extraordinary general meeting of shareholders, which must pass a special resolution for winding up by at least 75% of votes cast. A creditors’ meeting is held within one day of this resolution to appoint a liquidator (and possibly a committee of inspection).

Alternatively, by a special procedure, a majority of directors can pass a board resolution to wind up the company, without consulting shareholders, on grounds that the company cannot continue business because it cannot pay its debts. This resolution can only be passed if it is not reasonably achievable to wind up the company by other means. A statutory declaration must be filed with the Companies Registry within seven days of the resolution, verifying written statements (signed by the directors, recording the resolution that, among other things, the company cannot continue business because of its debts). The directors must appoint a provisional liquidator, and, give notice of the commencement of the winding up in the Government Gazette within 14 days. Creditors’ and shareholders’ meetings are then held within 28 days of filling the statutory declaration.

Creditors (and shareholders, if liquidation is started by special resolution) elect a liquidator at their respective meetings. If creditors and shareholders cannot agree, the creditors’ choice prevails. Creditors can appoint an inspection committee consisting of no more than five persons.

Substantive tests. See above, Initiation.

Supervision and control. The directors remain in control until the appointment of the liquidator. The directors’ powers cease on appointment of the liquidator, except where the committee of inspection or creditors sanction otherwise.

Protection from creditors. There is no moratorium on proceedings against the company. However, on the application of the liquidator, any contributory or creditor, the court can stay any action against the company on such terms as it thinks fit.

Length of procedure. Under the normal creditors’ voluntary liquidation procedure, a liquidator can be appointed in two to three weeks. Under the special procedure, appointment of a liquidator is likely to be much faster. The underlying rationale for this is to protect the assets of the company in emergency cases, where there may be a risk of dissipation of the company’s assets.

Conclusion. See above, Compulsory liquidation. However, the liquidator’s powers differ slightly. The liquidator must realise as many of the company’s assets as possible for distribution to its creditors.

When the company is fully wound up, the liquidator must prepare an account of how he has conducted the liquidation and disposed of assets. He must also call meetings of the company and its creditors. Within one week of these meetings, the liquidator must send a copy of the account to the Companies Registry. The company is dissolved three months after the account has been registered. Dissolution brings the company to an end.

Solvency voluntary liquidation

Objective. The aim of a solvent voluntary liquidation is to wind up a company when its shareholders no longer wish it to continue in business, to pay all the company’s creditors in full and to distribute any surplus to the shareholders.

Initiation. A majority of the company’s directors must make a declaration of solvency within five weeks before liquidation begins. An extraordinary general meeting is convened (with at least 21 days’ notice). At this meeting, shareholders must both:

- Pass a special resolution by at least 75% of votes cast.
- Appoint a liquidator.

There is no obligation on any person to commence a members’ voluntary liquidation. Any company registered in Hong Kong can be voluntarily liquidated, provided it meets the substantive test (see below, Substantive tests).

Substantive tests. The company must be capable of paying all creditors in full within 12 months from the start of liquidation, even if the overall liquidation process takes longer than 12 months. If, at any time, the liquidator discovers the assets are insufficient to achieve this, he must immediately call a creditors’ meeting. The liquidation is then conducted in the same way as a creditors’ voluntary liquidation (see above, Creditors’ voluntary liquidation).

Supervision and control. The directors of a company remain in control of the company until the appointment of the liquidator. The directors’ powers cease on the appointment of the liquidator, except where the company in a general meeting or the liquidator sanctions their continuance.

Protection from creditors. See above, Creditors’ voluntary liquidation: Protection from creditors.

Length of procedure. All creditors must be paid in full within 12 months of the date on which the special resolution was passed.

Conclusion. The liquidator winds up the company. All the creditors are paid, or provided for, in full within 12 months of liquidation beginning.

See above, Creditors’ voluntary liquidation, except that only a company meeting is required.
7. Which stakeholders have the most significant role in the outcome of a restructuring or insolvency procedure?

Re restructuring procedures

In a non-statutory workout or a statutory scheme of arrangement, the creditors have the most significant role in the outcome of the rescue as their unanimous (in the case of workout) or special majorit (in the case of scheme of arrangement) consent is required. In addition, if no liquidation proceedings against the company have yet been started, any dissenting creditor can take action to recover its debts or begin liquidation proceedings against the company as there is no moratorium.

Insolvency procedures

In a compulsory liquidation or creditors’ voluntary liquidation, the creditors also have the most significant role in the outcome of the liquidation. In a compulsory liquidation, it is often the creditors who initiate the process. In addition, the creditors can appoint the liquidator and the committee of inspection which supervises the liquidator is comprised of creditors. In a creditors’ voluntary liquidation, the creditors have the right to nominate a liquidator and the nomination takes precedence over any other person nominated by the company. The creditors can also appoint a committee of inspection to supervise the liquidation.

LIABILITY

8. Can a director, parent company (domestic or foreign) or other party be held liable for an insolvent company’s debts?

Directors and officers of a company are liable to the liquidator if they commit offences such as fraud or deception. In a number of situations, a liquidator can also seek a court order requiring certain directors or officers to either:

- Repay or restore property to the company.
- Provide compensation or contribute to the company’s assets.

A director can be personally liable if:

- He has given a personal guarantee for company debts. The director is liable to the creditor to whom the guarantee was made.
- Business was carried out with intent to defraud creditors, or for any other fraudulent purpose, and he was knowingly a party to the fraud. The standard of proof of intent to defraud is high and difficult to establish, particularly when liquidation has been in progress for several years.
- He (or a shadow director) has breached his fiduciary duties to the company and its shareholders.
- He has misapplied or retained the company’s property for his personal benefit (misfeasance).

Directors are also criminally liable for certain offences (such as misappropriation of property, for which they can be imprisoned).

If company accounts and records are destroyed, or falsified before or after winding-up begins, the party responsible (whether a past or present officer or shareholder) can be fined or imprisoned.

A parent company is a separate legal entity and is not liable for an insolvent subsidiary’s debts, unless it has given a guarantee for those debts.

SETTING ASIDE TRANSACTIONS

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

Transactions entered into by a company that subsequently goes into liquidation can be set aside in the following circumstances:

- Unfair preferences. An unfair preference occurs when an insolvent company makes a payment, or carries out another act, that puts a creditor in a better position than it would otherwise have held. A transaction is usually only an unfair preference if made voluntarily by the company, rather than as a result of a threat of creditor action.

A liquidator can apply to court to set aside an unfair preference made by the company within six months (or two years if it relates to an associate) before its liquidation. An associate is widely defined, but does not include a parent company. Transactions involving associates are presumed to be an unfair preference.

If the court finds that an unfair preference has been given, it can make any order it thinks fit to restore the position to what it would have been if that creditor had not been given the unfair preference. However, the court will not make this order if the rights of innocent third parties will be affected.

- Floating charges. Floating charges created within 12 months of an insolvent company’s liquidation are invalid and can be set aside by the liquidator, unless money is advanced to the company at the same time as, or after, the charge is created.

Typically, the liquidator will bring the application to challenge a charge by summons.

If a floating charge is found to be invalid, it is invalid even against a third party assignee of the charge. However, only the charge is invalid, so the obligation on the company to repay remains effective.

- Disposals. In a compulsory liquidation, any disposal of company property between the presentation of a petition and the making of a liquidation order by the court is void (section 182, Companies Ordinance). A recipient of funds or assets transferred must return them to the liquidator, unless the recipient applies to court to declare the disposal valid (this can be done either before or after the disposal). The court only declares a disposal valid if it is satisfied that the transfer does not have the effect of reducing the assets available for distribution to creditors.

If, after presentation of the winding-up petition, no liquidator has yet been appointed, the petitioner can challenge payments made by the company. After the winding-up order has been made, the
liquidator can apply to the court for a declaration that certain payments made by the company are void.

If the company has transferred funds or assets, the recipient must return them to the liquidator. However, where the funds or assets have been transferred to a third party, that third party is liable to return them to the recipient.

- Onerous property. With the court’s approval, a liquidator can disclaim onerous property within 12 months of the liquidation beginning. Onerous property includes:
  - unprofitable contracts;
  - property that cannot be realised by reason of its binding the possessor to the performance of any onerous act, or the payment of any sum of money;
  - leases made on unfavourable terms.

Only the liquidator may make the application.

The court generally seeks to minimise the effect on third parties’ interests under a disclaimer of onerous property. Therefore, any person interested in the disclaimed property can make an application to the court for an order that the disclaimed property be vested in the appropriate person.

Any person who suffers loss by the disclaimer of property is deemed to be a creditor of the company.

- Assets placed beyond the reach of creditors. A transaction can be set aside if a liquidator can prove to the court that it took place with the aim of placing company assets beyond creditors’ reach. There is no time limit for challenging transactions, but a claim is more likely to succeed if the transaction occurred shortly before liquidation. The company does not need to be insolvent at the time of the transaction or become insolvent as a result, to set aside the transaction.

The liquidator or any creditor can apply.

A transaction will not be avoided if the property was disposed of for valuable consideration and in good faith to a person who did not have notice of the intent to defraud the creditors.

- Extortionate credit transactions. If a company is being liquidated, the court can make an order either to set aside or to vary the terms of a credit transaction (that is, loan facilities granted to the company) if both:
  - the company entered into it within three years before liquidation;
  - it involves exorbitant payments or otherwise grossly contravenes ordinary principles of fair dealing.

The application can be made by the liquidator only.

The court can make orders affecting third parties’ rights, so any person who holds property as security for the purposes of the credit transaction may be required to surrender the property to the liquidator.

- Fraudulent trading. During liquidation, if it appears that any business of the company took place with intent to defraud creditors or any other person, or for any fraudulent purpose, the court can declare that a person who was knowingly a party to that business is personally liable for the company’s debts.

The Official Receiver, liquidator, or any creditor or contributory of the company can apply to the court for a declaration that any persons who were knowingly parties to the fraudulent trading are personally liable.

If the court has made a declaration that a person should be personally liable for fraudulent trading, that person must make up the loss. Where the benefit has been passed to an innocent third party, the third party is not required to disgorge the benefit.

CARRYING ON BUSINESS DURING INSOLVENCY

10. In what circumstances can a company continue to carry on business during insolvency or rescue proceedings? In particular, who has the authority to supervise or carry on the company’s business and what restrictions apply?

Circumstances

Workout. Subject to any contractual arrangements made with creditors, the company can continue carrying on business.

Bank workout. See above, Workout.

Scheme of arrangement. The company can carry on business before a scheme is approved. After this, the scheme is usually administered and implemented by administrators, whose rights and duties are set out in the scheme document.

Compulsory liquidation. If a liquidation order has been made or a provisional liquidator has been appointed, the liquidator or provisional liquidator takes control of all the company’s property.

A liquidator can only carry on the company’s business with the approval of the court or the committee of inspection. If approval is given, the liquidator can continue business only to the extent this is necessary to benefit the winding-up of the company. Generally, provisional liquidators have no power to continue carrying on business, unless the court order appointing them states otherwise.

Creditors’ voluntary liquidation. As soon as liquidation begins, the company must cease carrying on business, except to the extent this is necessary to benefit the liquidation. The approval of the court or inspection committee is not required to carry on business in these circumstances.

Solvent voluntary liquidation. See above, Creditors’ voluntary liquidation.

Authority/supervision

See above, Circumstances.

Intellectual property licences

If a company is a licensee of intellectual property, the liquidator may potentially disclaim such a licence as onerous property, if the contract either:
  - Is unprofitable.
  - Binds the company to the performance of any onerous act or payment of any sum of money (such as payment of licence fees).

See Question 9.

In addition, if the licence contains such terms, it may also be terminable by the licensor on the occurrence of liquidation.
ADDITIONAL FINANCE

11. Can a company that is subject to insolvency proceedings obtain additional finance (for example, debtor-in-possession financing or equivalent)? Is special priority given to the repayment of this finance?

There is no provision prohibiting a company from obtaining additional finance. Further, the liquidator in compulsory liquidation and creditors’ voluntary liquidation has the power to raise money on the security of the assets of the company. The security takes priority in accordance with the general rules on priority of creditor claims (see Question 2).

MULTINATIONAL CASES

12. What are the rules regarding recognition, concurrent proceedings and international treaties in multinational cases? What are the procedures for foreign creditors?

Recognition
Court orders obtained in foreign insolvency proceedings can only be enforced in Hong Kong if the court recognises those proceedings. When asked to recognise a foreign insolvency procedure, the Hong Kong courts will generally do so, exercising their discretion as a matter of comity. However, the court must balance its obligations to the foreign jurisdiction with the need to ensure that Hong Kong creditors receive fair treatment. Foreign judgments are unlikely to be enforced if Hong Kong creditors could be unfairly prejudiced. Surprisingly, even though Hong Kong is part of China, there is no formal basis on which a Hong Kong liquidation can be recognised in China.

Concurrent proceedings
In practice, if there are proceedings both in Hong Kong and abroad, the court has shown a willingness to co-operate with the foreign court.

International treaties
Hong Kong is not party to any international treaty relating to insolvency and the UNCITRAL Model Law on Cross-Border Insolvency 1997 (UNCITRAL Model Law) has not yet been implemented in Hong Kong.

Procedures for foreign creditors
The same procedures apply to both local and foreign creditors.

REFORM

13. Are there any proposals for reform?

Proposals for reform have been made for the following:

- **Provisional supervision.** A provisional supervision rescue procedure has been proposed to be used by companies that are having difficulties, but which have strong underlying businesses. The procedure will be conducted through the appointment of an independent third party, a provisional supervisor, who will take control of the company and formulate a voluntary arrangement proposal for creditors, with minimal court involvement. Importantly, there will be a moratorium on creditors’ claims within a specified timeframe.

The introduction of the provisional supervision procedure was recommended by the Law Reform Commission in 1996 and was first introduced to the Legislative Council (Legco) in 2000. However, it has stalled on a number of occasions due to the diverse views of a large number of stakeholders. One of the most controversial issues attracting public debate was whether employees’ outstanding claims should be paid, either in full or up to a certain limit, before the company could begin this rescue procedure. In October 2009, the Financial Services and Treasury Bureau (FSTB) conducted a three-month public consultation on a further attempt at launching this legislation. The FSTB finalised its conclusions from the consultation in July 2010. However, the FSTB’s latest proposal relating to employees’ outstanding claims is likely to remain controversial. Under the proposal, the insolvent company will still need to set aside a substantial amount of funds to cover outstanding employee entitlements such as arrears of wages, wages in lieu of notice of termination and severance payments, before provisional supervision can proceed.

The FSTB has indicated that it plans to launch a public consultation in late 2012 to consult the public on the major legislative proposals. Once these are finalised, it will aim to introduce a revised Bill to Legco by the second quarter of 2014.

- **Insolvent trading.** The FSTB has again proposed the introduction of insolvent trading provisions. This provides that a company's directors and shadow directors will be personally liable to compensate the company in certain circumstances. However, senior management will be excluded from liability under insolvent trading. Liability will arise if they allowed the company to continue trading and incur debt when they knew, or ought reasonably to have known that it was insolvent, or that there was no reasonable prospect of avoiding insolvency.

A provision on insolvent trading is intended to apply to companies generally and not only in the context of provisional supervision. However, these provisions would effectively serve as an incentive to induce responsible persons not to resort to insolvent trading before liquidation, but rather initiate the provisional supervision at an earlier stage.

- **Consolidating legislation.** There are plans to consolidate all insolvency legislation relating to individuals (regulated by the Bankruptcy Ordinance (Cap. 6), Laws of Hong Kong) and companies (regulated by the Companies Ordinance) into a single ordinance.

- **UNCITRAL Model Law.** The Law Reform Commission has concluded that Hong Kong should wait for further development of the UNCITRAL Model Law before national implementation (see Question 12).

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**Country Q&A**

**RESTRUCTURING AND INSOLVENCY**

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