Corporate Insolvency and Restructuring
This brochure is intended to complement our other publication called “Corporate Insolvency and Restructuring - A Creditor's Perspective”. Its aim is to highlight the insolvency process from the perspective of a debtor company, its directors and shareholders respectively.

This area of law is highly technical and demands experienced and authoritative professional advice in order that the many pitfalls which arise when any business is in financial difficulty can be minimised or perhaps even avoided altogether.

While every effort has been made to ensure the accuracy of the information contained in this brochure, it is only a summary and should not be relied upon as a substitute for detailed advice in individual cases.

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1. Introduction

The limited company is an artificial legal "entity" with rights and obligations which are distinct from those of its shareholders and directors – this is commonly referred to as the "corporate veil". In practice, this means that a company's shareholders can carry on a business while restricting or "limiting" their liability to the extent of the paid up capital of the company. However, the complexity of modern commercial life has necessitated substantial reform in this area of the law. This reform has increased the risk of personal liability for persons concerned with a company, especially when it is insolvent.

The relevant legislation in Hong Kong is founded principally on the English common law and the Companies Ordinance (Cap. 622) ("CO"). The legislation establishes that directors have specific obligations and duties which are of particular significance when a company is in financial difficulty. Generally, if directors act in accordance with these duties (to the required level of skill and care), it is unlikely that any transaction entered into by the company will be subjected to the scrutiny of the Court. However, this is not always the case once a company is in financial difficulty or is insolvent.

Although there has been a gradual shift in attitude towards trying to rescue viable businesses which are in financial difficulty, the present legislation is biased towards liquidating companies which are unable to pay their debts as they fall due. With that in mind, this brochure is aimed towards:

- directors and shareholders who wish to close down a business while minimising the potential liability to themselves;
- directors and shareholders who wish to rescue a business which has become insolvent for some reason; and
- directors and shareholders who have already encountered difficulties in relation to a corporate insolvency and require assistance in dealing with those difficulties.

2. The test of insolvency

The primary test of a company's insolvency is its inability to pay its debts as and when they fall due. This can be shown by the fact that the company

- has failed to comply with a statutory demand served under Section 178 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("C(WUMP)O") ;
- has insufficient funds or assets to satisfy a judgment; or
- cannot prove to the satisfaction of the Court that it is able to pay all its debts taking into account all prospective and contingent liabilities.

Where any of the above tests are satisfied, a winding-up petition can be presented to the Court. It is possible to “defend” a petition, although this is only on the basis that the unpaid debt can be disputed by the company in good faith and on substantial grounds.

Directors and shareholders are well advised to exercise great caution when determining whether a company is insolvent. If the company has obvious financial difficulties, then it is essential that the directors (and also the shareholders) continuously monitor the viability of the company, otherwise they may become personally liable for all the debts and liabilities of the company.

Common factors to consider when determining if a company is insolvent are:

- the issuing of post-dated cheques to creditors;
- inability to obtain funds from external sources;
- deficiency in the working capital and net assets of the company;
- failure to meet normal trade terms with creditors; and
- an unrealistic assessment of the ability of trade debtors to pay debts due to the company.
3. Alternatives to trading out

A number of choices face the directors and shareholders when deciding what to do with a business which has financial difficulties. The immediate reaction is to try to “trade out” of the problem. However, this is not always the most appropriate decision and there are at least 3 alternative solutions. These are:

• cessation of business;
• sale of the business; and
• liquidation.

Each of these options need to be considered, even if the directors and/or shareholders have fixed views on how they wish to resolve the problem.

3.1 Cessation of business

If the liabilities of the company are relatively small, consideration can be given to settling all these liabilities in full. Once paid, the company can then remain dormant for an indefinite period of time. Normally, keeping a company dormant is preferable to a formal liquidation, especially if it is likely that the company will resume trading at some time in the future.

On the other hand, if the directors and shareholders are not able to satisfy all the company’s liabilities then a liquidation is probably the only solution to consider.

On closing-down a business, various matters need to be considered. These include:

• consideration of the company’s position with its bankers;
• completion of unfinished contracts;
• sale or return of third party property;
• liability for warranties on goods sold prior to the cessation of business;
• collateral liabilities, for example, directors’ personal guarantees;
• collection of book debts;
• employees and their rights on dismissal;
• provident funds and pension funds;
• patents, trademarks and licences held by or granted by the company;
• relationship with agents (if any);
• tenancies and leases;
• hire purchase agreements;
• administrative matters such as redelivery of mail and the like; and
• termination agreements with senior staff/local directors.

3.2 Sales of the business

The sale can be to new parties/investors or to the current managers of the business who may try to finance a management buy-out. Broadly, the issues to be considered here include many of those mentioned immediately above. However, it cannot be stressed enough that it is always advisable that the sale is recorded in a formal written agreement dealing with, for example, the continuing relationship between the vendor and the purchaser, confidentiality, intellectual property rights and any financial warranties given by either party.
3.3 Liquidation

The liquidation of a company suspends the powers of the directors and as such, the powers of management and control are passed to the liquidator. Nonetheless, liquidation does not relieve the current or former directors or shareholders from any liability incurred prior to the winding-up, although it does protect them from incurring any further liability. As a commercial matter, unless major creditors are notified in advance, insolvent liquidation may adversely affect the credit worthiness of associated or group companies if the insolvent company is part of a large group.

4. Corporate insolvency – Available procedures

There are essentially 3 procedures by which an insolvent company can be wound-up or placed into liquidation. These are:

- compulsory liquidation (or compulsory winding-up);
- creditors’ voluntary liquidation; and
- creditors’ voluntary liquidation using the special procedure under Section 228A of C(WUMP)O ("Section 228A liquidation").

4.1 Compulsory liquidation

This usually arises where an unpaid creditor makes an application to the Court that a winding-up order should be made. If an order is made, the liquidation is deemed to commence at the time of presentation of the petition. Normally this procedure is used by a third party creditor to enforce a debt due from the company, although occasionally the shareholders or directors may wish to consider compulsory winding-up (which is relatively inexpensive) where there are few assets, a decision not to continue the business has already been taken, and where it will be possible for the company to cease trading immediately.

A compulsory liquidation usually involves the following steps:

- service of a statutory demand on the company under Section 178 of C(WUMP)O demanding payment for a debt which is not satisfied within 21 days; and thereafter
- presentation of a petition founded on the company’s failure to comply with the demand.

The hearing date may be four to six weeks or even longer from the date of the presentation of petition and unless the petition is successfully defended, a winding up order will be made and the Official Receiver will be appointed as provisional liquidator. In substantial cases “special managers” (agents for the liquidator) may also be appointed to assist in the day-to-day conduct of the liquidation.

Although winding-up petitions are normally based on a statutory demand, a petition can also be presented where the creditor is able to establish the company’s insolvency by some other means, for example, where the creditor has unsuccessfully attempted to enforce a judgment debt.

4.2 Creditors’ voluntary liquidation

In this case, the directors of the company convene meetings of the shareholders and creditors to resolve that the company should be wound up. In practice, these meetings should take place within one month after the decision of the directors to call them. At the shareholders’ meeting, a special resolution must be passed to wind-up the company and from that moment on, the company is deemed to be in liquidation. The meetings of the shareholders and creditors also decide who will act as liquidator. In the event of any disagreement, the creditors’ choice of liquidator will be preferred.
4.3 Section 228A liquidation

Under this procedure, the directors make the decision to wind-up the company at a board meeting. At that meeting, they resolve that they have made enquiries into the financial position of the company and in the light of those enquiries have formed the opinion that the company cannot, by reason of its liabilities, continue its business and convene meetings of the shareholders and creditors of the company. The board meeting also authorises one of the directors to make a statutory declaration which is then filed with the Registrar of Companies. This declaration states that:

- the company cannot, by reason of its liabilities, continue its business;
- it is necessary that the company be wound up and that such winding up should be commenced under Section 228A of C(WUMP)O because it is not reasonably practicable for the winding up to be commenced under another section of C(WUMP)O; and
- meetings of the company and of its creditors will be summoned for a date not later than 28 days after the delivery of the declaration to the Registrar.

At the same meeting, the directors appoint a provisional liquidator to deal with the company’s affairs pending the meetings of shareholders and the creditors. The liquidation commences from the time that the statutory declaration and certain other documents are filed with the Registrar of Companies.

When the creditors’ meeting is held, the creditors have a right to nominate another liquidator. In the event of any disagreement, the creditors’ choice of liquidator will be preferred.

4.4 Consequences of liquidation

In a compulsory liquidation only

From the date of presentation of the petition

- any disposition of the property of the company is void, unless the court orders otherwise;
- any execution, distress or other lawful enforcement is void; and
- the company, any creditor or contributory may apply to stay any legal action or proceeding against the company.

After the making of the order

- all proceedings are automatically stayed and no new proceedings can be commenced unless the Court orders otherwise; and
- the powers of the directors cease.

In all liquidations

- any change in the status of the shareholders or transfer of shares is void, unless the Court orders otherwise;
- any execution or attachment on the property of the company (e.g. a charging order nisi) which is incomplete at the commencement of the winding-up is liable to be set aside;
- the commencement of the winding-up provides the relevant date for unfair preferences (see 6.2.4 below) and avoidance of floating charges (see 7 below);
- claims of preferential creditors have priority over distraints taken within 3 months before the commencement of the winding-up;
- an application by way of seeking directions may be made to the Court for a stay of any proceedings against the company;
- interest stops running against an insolvent company from the commencement of its winding-up; and
- it is likely that all debts owed to and by the company are converted into Hong Kong Dollars from the commencement of the winding-up.
4.5 The liquidator and his duties

The liquidator is the person who is in charge of the liquidation of a company. He is entirely a creature of statute. The liquidator's duties are primarily owed to the creditors of the company as they are entitled to the assets after the payment of all the expenses of the liquidation. The position of a liquidator as regards former directors and shareholders must, at best, be neutral and, of course, is frequently hostile.

The liquidator will collect the company's assets, investigate its affairs and deal with claims by and against the company. Ultimately he will distribute the assets in a prescribed manner amongst the company's creditors in accordance with their rights. He has extensive powers to investigate the former management of the company and to compel disclosure of information. Directors and shareholders of insolvent companies should wherever possible cooperate fully with him, to avoid sanctions being invoked against them.

The liquidator in a voluntary winding-up is often an accountant specialising in this area of practice. In a compulsory winding-up, the Official Receiver who is a government official is normally appointed as liquidator in cases of public interest. Otherwise, the liquidator is usually an accountant from a professional firm which has satisfied certain criteria laid down by the Official Receiver.

5. Trading on – Restructuring

5.1 Principles

A liquidation does not necessarily mean that all the trading activities of the company will stop automatically. A liquidator may carry on the business so far as it may be beneficial to the winding up. In practice, liquidators (and also receivers appointed by a creditor with security) are usually receptive to well thought-out proposals for the acquisition of part or all of the assets of the company.

As a matter of experience, “rescue” or restructuring proposals are more likely to succeed where the company concerned has significant capital or tangible assets. It is more difficult where the company is in the service industry and the success or failure of the company depends on the goodwill which employees of the company have been able to develop in the past. In such cases, it may only be possible to continue the business of the company by establishing an entirely new operation.

As a general rule, businesses acquired from a liquidator or receiver may be purchased at very favourable prices. This is because a purchaser can continue the business with a greatly reduced level of debt. However, if the suppliers of raw materials to the company are limited then it may be necessary to provide these parties with some additional “comfort” in order to preserve continued supplies.

Where the vendor company is insolvent, a sale by a liquidator or a receiver is generally preferable over a sale by the company itself prior to liquidation. The reason for this is that there is a risk that the purchaser will become liable to all the creditors of the company by reason of the provisions set out in The Transfer of Business (Protection of Creditors) Ordinance. Generally, a liquidator or receiver can transfer the business and property of the company free of any potential liabilities arising under this ordinance.

5.2 Procedures

There are a number of ways in which the business and assets of the company can be acquired. These are mentioned in the next few paragraphs.
(a) Asset sale
The liquidator or receiver sells the assets to the purchaser either by private treaty or at auction. However, neither the liquidator nor receiver will give any warranty or “comfort” that the insolvent company has unencumbered ownership to any of the assets sold.

(b) Section 182 order
In a winding up by the court, any disposition of the property of the company, including things in action, and any transfer of shares, or alteration in the status of the members of the company, made after the commencement of the winding up, shall, unless the court otherwise orders, be void (Section 182 of C(WUMP)O). The commencement in a compulsory winding up is the presentation of the petition, so it is possible for a creditor to present a petition and for approval of the court to then be sought for a pre-arranged sale of assets of the company.

(c) Informal scheme
The CO contains specific provisions for Court approved Compromises or arrangements with creditors. Once approved, they are binding on all creditors provided that a majority in number representing 75% in value of the creditors of the company vote in favour of the proposal at a meeting held for that purpose. However, unless the assets of the company are very substantial, the costs of such a scheme may be prohibitive. The powers of the Court in approving a scheme are extensive and it may approve almost any form of compromise or arrangement.

(e) “Hive-downs”
Under a hive-down, the receiver of a company transfers its assets to a new company. As a matter of convenience, the shares in the new company can then be sold to a purchaser rather than the assets themselves.

6. Potential liabilities

6.1 Potential liabilities arising outside the Companies Ordinance

(a) Orders 48 and 49B, rules of the High Court
Under this rule, a judgment creditor has the right to examine directors as to the ability of the company to satisfy and pay a judgment debt. Examinations of this kind are severe and it is unlikely that any director can avoid being examined by resigning prior to the entry of the judgment. It is also unlikely that a director can avoid questions directed to establishing whether the company, if liquidated, would be able to pursue the directors personally.

(b) Piercing the corporate veil
In appropriate cases, a creditor may seek to “pierce the corporate veil” by issuing proceedings directly against the directors and/or shareholders. In very serious cases, these proceedings may also be coupled with a “Mareva injunction” freezing the directors’ personal assets.

(c) Breach of directors’ common law and fiduciary duties
These duties are present irrespective of whether the company is insolvent, but, once the company is insolvent or near insolvency, the directors must take into account the interests of the creditors.

6.2 Potential liabilities arising under the Companies Ordinance

(a) Criminal provisions
There are a number of provisions in the C(WUMP)O which create criminal offences in relation to the conduct of certain parties prior to any liquidation. These provisions are as follows:

- Section 271 – offences by officers of companies in liquidation
- Section 272 – falsification of books
- Section 273 – frauds by officers of companies which have gone into liquidation
• Section 274 – failure to keep proper books of account
• Section 275(3) – fraudulent trading.

With the exception of Section 275(3) discussed at paragraph 6.2.5 below, these offences are seldom prosecuted in practice.

(b) Examination provisions

There are also a number of provisions in the C(WUMP)O which create powers for the liquidator to examine the conduct of certain parties. These provisions are as follows:

• Section 286A – public examination
• Section 286B and 286C – private examination
• Section 276 – examination into the conduct of officers in conjunction with misfeasance proceedings.

(c) Recovery provisions

There are a number of provisions in the C(WUMP)O which assist the liquidator in recovering the assets of the insolvent company. These include:

• Section 266 – unfair preference
• Section 275 – fraudulent trading
• Section 276 – examination into the conduct of officers of the company in conjunction with misfeasance proceedings.

6.2.1 Public examination

Section 286A applies where a winding-up order has been made by the court and (i) where the Official Receiver or liquidator has reported that fraud has been committed in relation to the company’s affairs, or (ii) on application of the Official Receiver or the liquidator of the company. The examination is public and creditors may also attend to ask questions. The Official Receiver or liquidator who made the report or applies for the public examination procedure will take part in the examination. The parties who may be examined are (a) past or present officers, (n) any past or present provisional liquidator or liquidator, (c) any past or present receiver or manager, and (d) any person who is taking, or has previously taken part in the promotion, formation or management of the company.

6.2.2 Private examination

Sections 286B and 286C apply to (a) any officer, (b) any person concerned with the company property, (c) any debtor and (d) any person “capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company”. This definition includes, for example, the company’s professional advisers. Section 286B is also sufficiently broad to include the shareholders of a company where they have played an active role in the management of the business. Examinations under section 286C are similar to those under Order 48, Rules of the High Court mentioned at paragraph 6.1(a) above.

Sections 286A to 286C (or their equivalents in the United Kingdom) have been the subject of much litigation and legal discussion in the past few years. The outcome is that it is essential that anyone faced with an application, to seek urgent legal advice, lest their position be prejudiced.

6.2.3 Misfeasance

The terms of Section 276 are wide and comprehensive. In summary, the provision provides a method of establishing claims against (a) any past or present officer, (b) any past or present provisional liquidator or liquidator, (c) any past or present receiver or manager, or (d) any person who is taking, or has previously taken part in the promotion, formation or management of the company.
An application under the section can be made to the Court by the Official Receiver, a liquidator or any creditor. The Court has very wide discretion in determining any application and can make an order for restitution of property. One example where this provision has been used is the recovery of excessive remuneration paid to the directors.

6.2.4 Unfair preference

If a disposition was made in favour of a creditor which has the effect of putting that creditor into a better position in the company’s insolvent liquidation than that creditor would otherwise have been, and the company had been influenced by a desire to prefer, the transfer would be regarded as an unfair preference. If the unfair preference was made at a relevant time, the relevant transaction is void and the liquidator can recover any money paid and any property transferred. A time is a “relevant time” if:

(i) the company was insolvent at the time of the preference, or became insolvent as a result thereof; and

(ii) the preference was given within 6 months (where the parties are not associates) or 2 years (where the parties are associates) before the commencement of the winding up.

An unfair preference will generally not be established if:

• the transaction was not influenced by the desire to prefer one or more creditors, but rather to achieve the survival of the business of the company;

• the party to whom the preference was made was not an existing creditor (i.e. a new creditor) at the date of the relevant transaction;

• the company was solvent and able to pay its debts;

• the payment was made bona fide to avoid threatened legal proceedings; and/or

• the payment was made or security granted under bona fide commercial pressures.

A few examples of when an unfair preference may arise are as follows:

• Guarantees
  Where directors or shareholders have guaranteed the obligations of the company, there is an obvious personal incentive to repay all these guaranteed obligations in priority to any other liability of the company. Payments made in these circumstances, may be avoided if they are made within 2 years preceding the liquidation of the company. If any payment can be avoided, the party who received the payment is obliged to repay it to the liquidator.

• Payments to directors
  Most creditors are able to avoid the effect of Section 266 by “pressing” sufficiently firmly for payment. A director, however, cannot be said to press the company for payment while he remains a director.

• Payments to members
  While there is nothing, in theory, to prevent a member “pressing” the company for payment, a liquidator is likely to closely examine all these payments especially if they involve substantial amounts of money. Accordingly, there is a risk that any such payment may be set aside.

6.2.5 Undervalue transactions

A liquidator is empowered to look back as far as 5 years from the date of commencement of winding up (regardless of whether the transaction was entered into with a person connected with the company) to review and apply to the court to set aside suspicious transactions where the company received no consideration or consideration significantly less than the value of the consideration provided by the company.

To apply to set aside a transaction at an undervalue under section 265D of C(WUMP)O, the liquidator must prove that at the time the transaction took place, the company was insolvent or became insolvent as a result of it. Note that if the transaction took place with a connected person (otherwise than by reason only of being its employee), there will be a presumption that the company was insolvent at the relevant time.
The following may be considered to be transactions at undervalue if the company:

- makes a gift of property;
- binds itself to supply goods or services for no consideration;
- purchases an asset at a significantly higher value, or sells an asset at a significantly less value than its value;
- accepts repayment of debt in a sum significantly less than the recoverable value of the debt; or
- gives a guarantee or indemnity and received by way of benefit significantly less than the value of the benefit conferred by the guarantee, or takes a guarantee or indemnity against a benefit which is significantly less in value than that of the guarantee itself.

### 6.2.6 Fraudulent trading

This provides that if in the course of a winding up, it appears that any business of the company has been carried on with the intent to defraud creditors or for any fraudulent purpose, then the Official Receiver, the liquidator or any creditor or contributory may make an application to the court for a declaration that those persons who were knowing parties to the carrying on of the business in this way are personally liable without limit for all the debts and liabilities of the company. As stated at paragraph 6.2(a) Section 275(3) also creates a criminal offence.

Unfortunately the precise interpretation of this provision in Hong Kong is unclear. There are no clear case authorities in Hong Kong and the case law in the United Kingdom is inconsistent. The better view is that the necessary intention will be established where, for example, the company makes a contract with a third party to supply goods and at that time there was no reasonable prospect that the third party would be paid and the directors wilfully disregard or prejudice the ability of the third party to receive payment. Therefore, for any liability to arise, it appears that the individual concerned must have knowledge of the financial position of the company and even in the light of that knowledge, deliberately proceeds to incur further credit whilst acting in some way which reduces the prospect of payment.

### 6.2.7 Misfeasance

This provision has already been discussed at paragraph 6.2.3. However, by way of example, a director may be liable under this section if:

- he has received money or property of the company as a result of misfeasance; the money so received;
- he had known and approved of any payment to himself and others; the whole amount paid to all of them;
- he had made a misrepresentation to others amounting to misfeasance; the amount of the damage caused;
- if he was fraudulent, or dishonest, or failed to exercise discretion and judgment; the amount of the damage caused; and/or
- if he left the compliance with the statutory obligations of the company entirely to another director and the company’s auditor; the amount of the damage caused.

It should be noted that for any liability to arise, it is not necessary for the director to know all the details of the relevant acts of misfeasance, its precise nature or the intended victim (if any).

### 6.2.8 Disqualification

Sections 168C to 168T of the C(WUMP)O have been introduced to improve the corporate responsibility of directors. Under the provisions, the Official Receiver or Financial Secretary can apply to the Court for an order that the director shall not, without the Court’s leave, be a director, provisional liquidator, liquidator, receiver or manager of or in any way concerned with the promotion, formation and management of a company, for up to 15 years.
An application can be made in the following circumstances:

- where the director has been convicted of an indictable offence concerning the promotion, formation and management of a company;
- where the director has been in persistent default of the provisions of C(WUMP)O to file returns or other documents with the Companies Registrar;
- where the director has been guilty of an offence (whether convicted or not) under Section 275; or
- where the director’s conduct makes him “unfit” to be a director.

If any person acts as a director while disqualified or acts on the instructions of a person whom he knows to be disqualified, then that person becomes personally liable for all the debts of company incurred whilst acting in contravention of C(WUMP)O.

7. The conduct of a liquidation

The conduct of a liquidation can be broadly summarised as follows:

The liquidator will step in and assume control of the company’s affairs very quickly. However, the extent of his powers may initially be limited until his appointment is ratified by the creditors of the company. It is not uncommon that an application is made at an early stage for the appointment of a “special manager”. In larger cases, it is also common for a “committee of inspection” to be appointed. This committee consists of representatives of the creditors who supervise the conduct of the liquidation.

The directors and company secretary must provide the liquidator with a statement of affairs detailing the assets and liabilities of the company together with the names, addresses and occupations of the creditors and their respective security. The directors may also be required to complete a questionnaire about various aspects of the company’s affairs.

The liquidator will decide, bearing in mind the interests of all creditors, what is to be done with the assets of the company and in particular, will decide whether any property of the company needs to be disclaimed as onerous.

As has already been pointed out, the liquidator has various specific statutory powers to assist him in the collection of the assets of the company. In addition to those mentioned earlier, the liquidator will also consider whether any security given by the company can be set aside under Sections 337 of the CO and/or 267 and 267A of the C(WUMP)O. These provide as follows:

- **Section 337 CO**
  If the statement of particulars of charge (Form NM1) and a certified copy of the charge document for any registrable charge are not delivered to the Registrar of Companies within 1 month of the creation of the charge, then the charge itself is void as against the liquidator and any creditor of the Company.

- **Sections 267 and 267A C(WUMP)O**
  A floating charge given by the company over its assets may be declared void if created within 12 months of the commencement of the liquidation except to the extent that the company was solvent immediately after the creation of the charge or to the extent of new advances/monies given to the company in consideration of the charge. For persons connected with the company, the period has been extended to 2 years before commencement of the liquidation. Under such scenario, it is not necessary to establish that the company was insolvent at the time or became insolvent immediately after the creation of the charge.

If the liquidation is protracted, the liquidator is obliged to call periodic meetings to give an account of his dealings and the conduct of the liquidation.
The liquidator will also distribute the realised assets to the creditors of the company once he has adjudicated the claims of all the creditors. To help him with this assessment, he will ask for the submission of a proof of debt. Where any claim is the subject of dispute, the company’s management may well be called upon to assist in the process of evaluating its merits. In due course, the liquidator will compute the applicable dividend i.e. the percentage of each creditor’s claim payable and will issue notices to the creditors of his intention to declare and pay a dividend.

When all the assets have been realised and nothing further is to be done, the liquidator will seek his release and the company will be dissolved, bringing it to an end.

8. Employees

The employees of a company which has gone into liquidation have preferential rights, i.e. they are entitled to be paid in priority to the ordinary unsecured creditors of the company and also in priority to the rights of a creditor who has the benefit of a floating charge.

The law in this area has changed on many occasions and is now very complicated. Briefly, the following entitlements are fully preferential:

- arrears of wages for up to 4 months not exceeding $8,000 in respect of each employee;
- severance pay or long service payments not exceeding $8,000 in respect of each employee;
- compensation payments due to employees under the Employees’ Compensation Ordinance (Cap. 282);
- wages in lieu of notice not exceeding the lesser of one month’s wages or $2,000 per employee; and
- all accrued holiday pay.

Where it appears that an employer has failed to pay wages, wages in lieu of notice or severance payments, employees may be entitled to ex-gratia payments from the Protection of Wages on Insolvency Fund. In general, these payments correspond with the sums mentioned above, but in addition, employees are entitled to half the excess of their severance payment entitlements.

The appointment of a receiver or liquidator (other than a liquidator appointed in a compulsory liquidation) does not necessarily terminate the employment contracts of the employees. Nonetheless, employees who are “kept on” by the receiver, liquidator or special manager are well advised to ascertain the terms of their continued employment.

9. Misconduct

If local management is suspected of having been engaged in misconduct, then senior management overseas or the shareholders themselves should consider the following:

9.1 Investigation

Any director is entitled to inspect the accounting records of the company of which he is an officer (Section 374 CO), regardless of whether the records are kept in Hong Kong or outside Hong Kong. Section 375 of CO provides an express right to the director to obtain copies of accounting records during inspection.

An early investigation is essential if any legal proceedings are contemplated. This is largely because it assists in preserving evidence and also enables an informed decision to be taken whether legal action should be pursued.
The rights of a director mentioned above apply to shareholders as well but with much limited scope. Section 740 of the CO allows shareholders representing at least 2.5% of voting rights, or five or more shareholders, to apply to the court for an order allowing inspection of a company’s records or documents. The court has discretion to make such an order only if it is satisfied that the application is made in good faith and the inspection is for a proper purpose. Therefore it may be necessary to procure the appointment of a director to start the process of investigation.

9.2 Proceedings

A number of strategic decisions need to be taken as soon as the facts of the alleged misconduct have been ascertained. It is possible that the articles of association of the company or a shareholders agreement will include rights and powers in favour of local management to “veto” any action. Such provisions may make it undesirable or impossible for the company to pursue the offenders because, generally as a matter of law, it is the company itself which has any right of action. However, depending on the nature of the alleged misconduct, it may be possible for the shareholders of the company to mount a claim directly against the offenders. If proceedings are initiated, consideration should be given whether any emergency remedies such as a “Mareva injunction” (freezing the assets of local management) should be sought.

Options for recovery remain available even if the company is in liquidation. As indicated above, the remedies mentioned under sections 275 and 276 of C(WUMP)O are available to creditors and shareholders and not just the liquidator.

If there are technical difficulties in taking any action, then the liquidation process may provide a solution. A liquidator has extensive powers to investigate the company’s affairs and to examine its officers. Often the appointment of a provisional liquidator by the Court is sometimes the only way to provide a degree of protection to the assets of the company.

Lastly, the liquidator has the right to sell any claim that he may have against a third party in the same way as any other asset of the company, and if he has no interest in pursuing the claim himself (or no funds to do so), there is no objection in principle to such a claim being purchased and pursued by a third party.
Want to know more?

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Whilst every effort has been made to ensure the accuracy of this publication, it is for general guidance only and should not be treated as a substitute for specific advice. If you would like advice on any of the issues raised, please speak to any of the contacts listed.