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*Cross Border Insolvency Issues in Hong Kong:
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Cross Border Insolvency Issues in Hong Kong

1. Introduction

The focus of this paper is on international workouts in Hong Kong as well as the role and treatment of foreign creditors in such situations. We shall discuss both formal and informal workouts, with minor references to also formal insolvency proceedings.

For the purpose of this discussion, and pursuant to the “One Country Two Systems” regime, the Peoples’ Republic of China (“PRC”) is treated as a foreign jurisdiction to Hong Kong.

Prior to the Asian Financial Crisis in 1997/98, workouts in Hong Kong were relatively few and far between. With the economy in a boom since at least the early 1980’s, financial lenders were generally in positions of relative advantage when dealing with delinquent debts. They sold off the security, appointed receivers or liquidators who were able to realize businesses or assets at fairly good prices. Since 1997/98, market sentiments have been at historic low, and there have been two occasions over the last five years when Hong Kong actually experienced negative GDP growth rates (at current prices). This had not happened in the last twenty years or so, not even when Hong Kong went through the banking sector turmoil in the early 1980’s. From 1997/98, workouts have become a practical and more commonly used alternative to formal insolvency proceedings to financial lenders and debtors alike.

2. Workouts, Restructurings and Turnarounds

Formal workouts in the Hong Kong context are often called restructurings or turnarounds, which are unfortunately and invariably linked to “haircuts” for financial lenders. These are also closely related to the disposal of “listed shells” of companies (see below). However, formal workouts in the Hong Kong context do not necessarily (and in fact rarely) save the original business (or even a part thereof) of the debtor.

It should be noted that, in the Hong Kong context, the vast majority of businesses (including many large listed “public” companies) are owner-run or family controlled. There are distinct major shareholder groups for most listed companies. This being so, the affairs and financial position of these companies are inextricably and directly linked to those of their majority owners. When faced with financial difficulties, management of these companies often place the interest of their majority owners in priority to those of the company, the “minority” shareholders and somewhat naturally the creditors. These are, of course, issues concerning proper corporate governance in general.

Due to over trading, mismanagement, outright fraud or a combination of these and other factors, it is not uncommon for businesses of companies in workouts to have been stripped to their bare bone by the time the workout process starts. Companies undergoing workouts in terms of billions of dollars of debt are known to have no operating office, retaining a few unqualified staff and maintaining little, if any, by way of available books and records. Faced with these, options available to financial lenders are very limited.

More than 80% of formal workouts are estimated to involve principally debt rescheduling work as opposed to genuine business reorganisation and restructuring. In the vast majority of these cases, the standard analysis by independent financial accountants for financial lenders will include a comparison of the return to creditors from a debt rescheduling to that from liquidation. “Haircuts” of 50% of the debt have become the starting point of negotiation of the debtors. In a case involving debts of close to HK\$4 billion, if not for the objection of one bank (for reasons other than pure

financial), the bank group comprising over 20 bankers and financial institutions would have accepted a haircut of 97% of the debt!

One peculiar feature of most Hong Kong restructurings is the absence of any core assets or business physically in Hong Kong. Practitioners have only seen too many cases of listed companies having only rented offices in Hong Kong, but with all their assets and investments in China and held through layers of intermediary holding companies. To complicate matters, these intermediary companies are often incorporated in various tax haven countries, the most common of which are Bermuda, the British Virgin Islands and the Cayman Islands. Financial lenders realise, often too late, that their lending was made to, for example the ultimate listed holding company of a group, but the assets and businesses are actually held by or through off shore companies which have no direct exposure to any financial institutions. The assets are divorced from the liabilities and corporate guarantees are not worth the paper on which they were written.

The publicity and negative impact of most formal restructurings make many of these difficult to complete. Also, financial lenders often do not get a good return. On the other hand, most informal restructurings tend to be low profile, relatively easier to complete and lenders tend to get a quicker and often better return. In either of these cases, the effective sale of a listing shell is often involved. There are pros and cons to all of these.

3. *The legal and regulatory framework*

Under the “One Country Two Systems” regime, Hong Kong still applies and practises the British based legal system. Still imaged on the UK 1948 Companies Act, there is no separate legislation on corporate insolvency and restructuring (there is, however, separate legislation on personal bankruptcy and debt restructuring). Legislation on corporate insolvency and restructuring is enshrined as parts in the Companies Ordinance and its related subsidiary legislation (e.g. the Companies (Winding-up) Rules).

Provisions on “Schemes of Arrangements” form the backbone of most formal restructurings, although contractual arrangements are also commonly used. These terms carry their usual meaning and interpretation under most common law jurisdictions and we do not propose to explain them in detail here.

Listed companies are regulated and governed by, inter alia, the relevant Board Rules of the Stock Exchange of Hong Kong, as well as terms of the Listing Agreement.

As many companies listed in Hong Kong are incorporated in various tax haven jurisdictions, the laws of the relevant countries will also apply in any restructuring. It is therefore very common for approvals to any formal schemes of arrangement to be sought from both the Hong Kong Court as well as from a Court in the place of incorporation of the companies concerned.

The rest of this paper will discuss restructuring, formal and informal, involving a listed company in Hong Kong.

4. *Sale of a listed shell*

When a listed company goes into liquidation, the listing status may be cancelled by the Stock Exchange. Prior to cancellation, or before the company goes into liquidation, such listing status, either on its own, or together with whatever assets, liabilities and operations, may be sold or “transferred”. Since the Asian Financial Crisis in 1997/98, there have been over 20 such sales either by the major shareholders, provisional liquidators or liquidators. The prices of these listed shells ranged from HK\$10 million to well over HK\$100 million. Faced with the alternative of a total write-off of the value of the listing status, any salvageable value is significant and relevant to both creditors and shareholders of these companies.

Commonly there are two ways of disposing of the listing status of a listed company in financial difficulties ("LCFD"). One is by the major shareholder who also invariably controls the Board of Directors. The other is by the provisional liquidator or liquidator once formal liquidation procedures have commenced. It is worth noting that, under current listing rules, the liquidation of a listed company does not automatically and immediately terminate the listing status. There is a "breathing space" of up to at least 18 months for the listing status to be salvaged or transferred. It is this window of opportunity that insolvency practitioners value as, in a lot of the recent cases involving LCFDs, this is the only avenue of realising any value at all to meet the fees of the insolvency practitioner and other professional advisors of the company, and to bring about return of some sort to its creditors and shareholders.

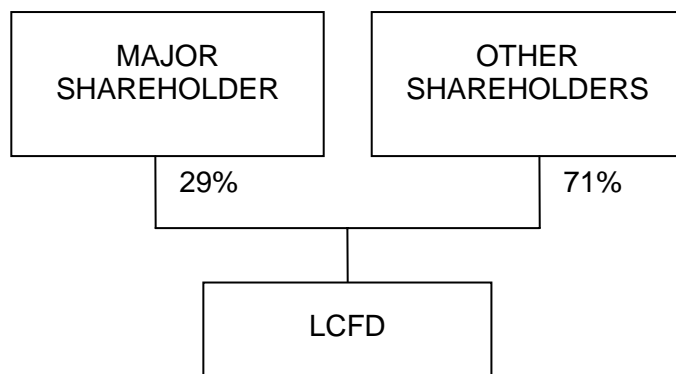
First, let us look at the mechanisms of the two types of sale of the listing status. For simplicity, we call a shareholder driven process the "Shareholder Sale" and an insolvency practitioner driven process an "IP Sale". Notably in most cases in recent years, the financial positions of the LCFDs are so bad such that there are no substantial assets or even operations remaining at all. The "attraction" to the investor or white knight is invariably if not exclusively the listing status, with the "purchase" effectively resulting in the investor achieving a "back-door" listing on the Hong Kong Stock Exchange.

5. **Sale by shareholders**

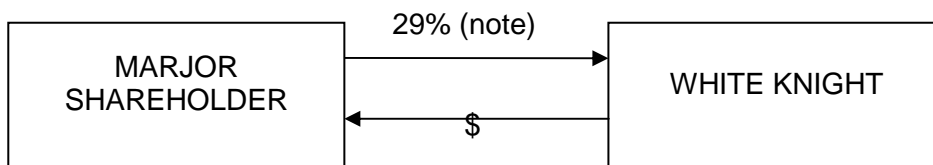
This is how a typical Shareholder Sale works. Most are informal workouts without the need to involve the Court. The major shareholder and CEO of a LCFD will try to hold the banks and creditors at bay by suggesting, via press releases or otherwise, that the LCFD is in discussions with a number of potential investors or white knights. Banks and creditors should therefore be patient and should even seriously consider providing bridging finance for working capital. The shareholder and CEO will then try to persuade the banks and creditors individually to accept certain debt restructuring proposals by the prospective white knights. The shareholders and CEO will avoid insofar as possible a meeting of all banks or creditors, let alone the formation of any formal or even informal "Creditors Steering Committees". It is because the banks and creditors may then be asked by the major shareholder and CEO to accept different restructuring terms without knowledge of what others may be offered or getting. When there appears to be a chance of most of these banks and creditors accepting various restructuring terms, the major shareholder and CEO will arrange to dispose of his direct and / or indirect shareholding in the LCFD to the new investor, or its representatives. Often, these new investors or white knights are friends or associates of the CEO themselves, or are introduced to them through mutual contacts. In recent years, most investors or white knights are or claim to have PRC background and connections, and their true identity is often a mystery to many. Completion is usually conditional, amongst others, upon the banks and creditors eventually agreeing to some form of restructuring.

Diagrammatically, this process may be illustrated as follows:

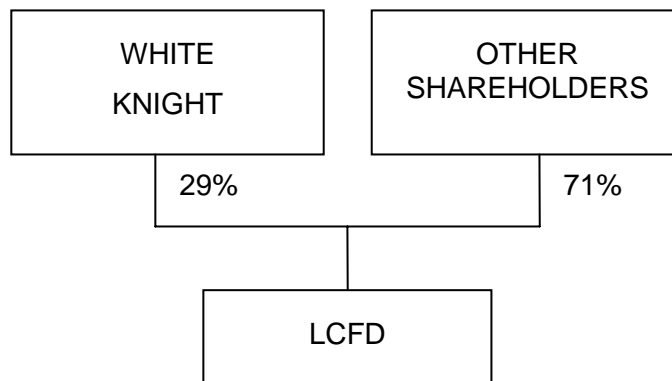
Before



Sale



Note : sale of a block of shareholding exceeding 30% may trigger a general offer to buy all shares
After



The white knights or their representatives by this time would have often already been introduced to the banks and creditors. The white knights would therefore be in a position to assess the practical likelihood of these creditors accepting any restructuring (or more commonly a "debt rescheduling") proposal. Before the major shareholder and CEO execute any formal papers with the white knight to transfer formally any shareholding, the issue of whether a general offer to the public will also be considered, as required under the Listing Rules

The directors on the Board are then changed. The white knight will ensure that he has overall control of the Board ("the New Board"). The New Board will follow up on the debt rescheduling negotiations with banks and creditors. With injection of cash or other assets into the LCFD, banks and creditors may agree (on an individual contractual basis) to a rescheduling of their respective debts. The debt rescheduling may also be done through a formal scheme of arrangement under the provisions of the Companies Ordinance. But this is relatively rare in a Shareholder Sale.

6. Sale by creditors

Another way of disposing of the listing status is by an IP Sale. Since recently, provisional liquidators have been given express powers by the Court to assist with the restructuring of a company. As a matter of fact, over the years, the Court has approved numerous restructuring or debt-rescheduling proposals put forward by insolvency practitioners. Nearly in all cases, formal insolvency procedures (usually liquidation) have already commenced (albeit some only up to the stage of filing a winding-up petition but before the making of any winding-up order). After appointment of insolvency practitioners as either provisional liquidators or liquidators, the powers of directors cease. Hence, the directors can no longer act for the company. This is also true for cases where receivers and managers have been appointed under the terms of a debenture, usually given in favour of a bank.

Upon the appointment of (provisional) liquidators, trading of shares in a LCFD will be suspended immediately. It is, however, very likely that trading of the relevant shares has already been suspended, as a result of the filing of the liquidation petition or similar proceedings, or for other reasons as set out in the Listing Rules.

In an IP Sale, there is normally a lot more transparency for all concerned. For professional reasons, the insolvency practitioner would tend to be more prone to using a Court supervised Scheme of Arrangement ("Scheme") procedure to effect any sale of the listing status. This sale is also often linked to a related restructuring or debt-rescheduling proposal put by the white knight to the banks and creditors, who will by now have formed informal, if not formal, Creditors Steering Committees to negotiate with the insolvency practitioner and the white knights collectively.

Once commercial terms of the restructuring or debt rescheduling have been reached, these terms are voted on and confirmed by shareholders and creditors through the process of a formal Scheme, as provided for in the Companies Ordinance. Essentially, this involves the putting forward initially to the Court a proposal setting out not just these commercial terms, but also plans and timetables for meetings of creditors and shareholders to vote on these terms. In most cases, professional opinion and valuation reports are also available for the creditors and shareholders to consider the proposal. Once the Court endorses this initial proposal, the relevant meetings will be convened and held for creditors and shareholders to consider and vote on the terms of the restructuring or debt rescheduling. The proposal must be supported by a majority in number representing 75% in value of the creditors and shareholders. Approval needs to be obtained from both meetings of shareholders and of creditors. The Court will then formally sanction the Scheme, which will then be binding on all creditors and members.

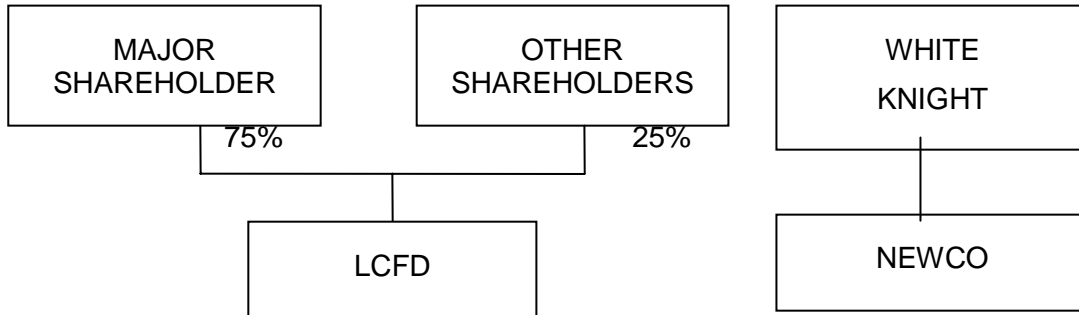
It has been suggested that, in an insolvent liquidation, shareholders have no interest in the outcome or proceedings. However, in a number of cases recently, the Court has confirmed that approval from shareholders must be given for sale of the listing status, because after all, it is the very shares registered in the names of individual shareholders that are to be physically sold and transferred to the white knight. Yet, the Court has also suggested that the consideration to be given to the shareholders should be only nominal (say 5% of the total consideration) when compared to creditors.

So, what actually is involved in an IP Sale? A company controlled by the white knight, Newco, will make an offer to buy all shares of the LCFD. Consideration to be given to the shareholders of the LCFD will be in the form of shares in Newco. Banks and creditors of the LCFD will be asked to agree to the Scheme in consideration for cash, shares, convertible notes or other financial papers in Newco, or any combination of the above (to be payable under the terms of the proposed Scheme). The listing status of the LCFD is effectively "transferred" to Newco by way of "introduction" whereby Newco is to take up a new listing status upon the surrender of LCFD's existing listing status. Hence, virtually all such "sales" of listing are conditional upon agreement of the Hong Kong Stock Exchange and the successful listing of Newco.

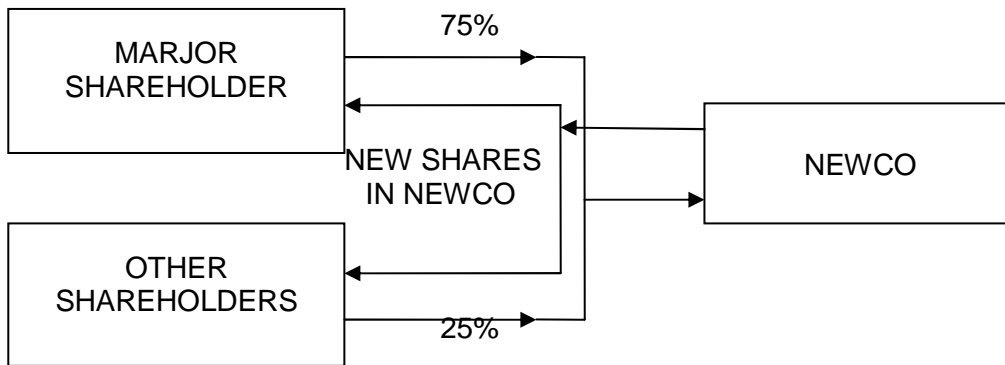
Newco then severs its link with LCFD (which by now has become its wholly owned subsidiary) by disposing of all shares therein to the insolvency practitioner for a nominal consideration. The insolvency practitioner will hold such shares on trust for creditors of LCFD. If already in liquidation, the liquidation of the shell of LCFD will continue through its course to completion. The insolvency practitioner will invariably take up the role as the Scheme Administrator in the distribution of cash and / or other proceeds to the shareholders and creditors whose claims have been adjudicated and confirmed. Completion of the liquidation will usually follow shortly after completion of the administration of the Scheme.

Diagrammatically, this process can be illustrated as follows:

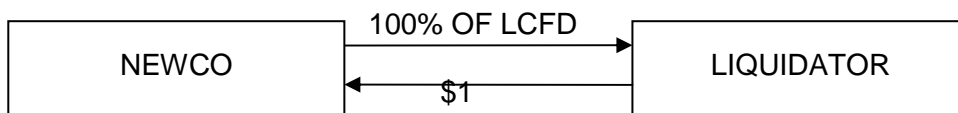
Before



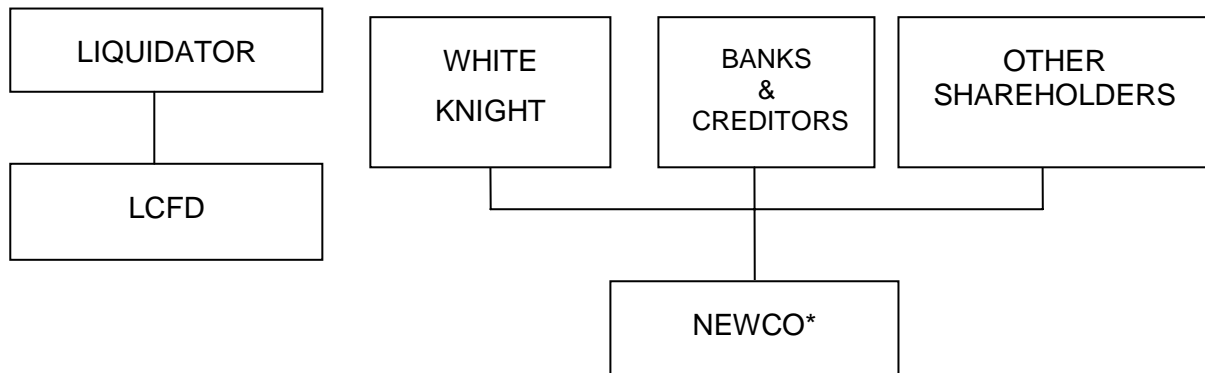
Sale



Transfer



After



* Obtains listing by way of "introduction"

7. Other issues and considerations

The above are just but two common (and simplified) ways of disposing of the listing status of LCFDs. There are numerous others as each case may require a tailored-made arrangement to deal with particular features of the shareholding, debt profile and the requirements of the white knight. When the restructuring scheme of a LCFD is duly approved, and if the LCFD has not yet been formally put into liquidation (despite the fact that provisional liquidators may have been appointed by the Court), any petition for the liquidation of the LCFD may be withdrawn and the appointment of the provisional liquidators terminated.

Under the current Listing Rules, and commencing from the suspension of trading in shares of LCFD, there is a three-stage delisting process, with each stage covering 6 months. There have been many situations when the third and final stage has been extended pending the finalisation of complex restructuring or debt-rescheduling negotiations, or pending proposals or arrangements to be approved by the Court. Currently, however, plans are afoot to amend the Listing Rules. Amongst the various proposed changes, it is expected that the proposal to cancel immediately the listing of companies in liquidation as the "going concern" status no longer applies will be met with strong opposition from practitioners.

8. Role and treatment of foreign creditors

Laws in Hong Kong are not territorial. They apply to all and sundry. They do not give preference to local creditors. Hence, there is no practical difference between local and foreign creditors in insolvency and restructuring proceedings in Hong Kong, be they formal or informal.

However, it should be noted that, for companies which are incorporated in jurisdictions other than Hong Kong, the laws of the relevant countries will apply to assets and proceedings outside of Hong Kong. Also, when assets and proceedings are in China, the local PRC laws apply. There is no mutual recognition or enforcement of Court proceedings or orders between Hong Kong and China.