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Hong Kong consults on reform of its corporate insolvency law – the derivatives angle.

Introduction

With the recently published Consultation Document *Improvement of Corporate Insolvency Law Legislative Proposals* (April 2013), Hong Kong has finally revived its belated efforts to update the corporate insolvency and winding up provisions in the Companies Ordinance (Cap. 32 of the Laws of Hong Kong) (the "**CO**"). This consultation is part of the exercise to overhaul the CO[1] and the plan is to introduce an amendment bill to cover these proposals together with the provisions on the statutory corporate rescue procedure and insolvent trading[2] to the Legislative Council in 2014/2015.

This consultation covers a number of aspects of winding up of which the proposals on voidable transactions are of most importance to derivatives practitioners and will be the focus of this Alert.

Key Takeaways:

- Courts are proposed to be given the power, upon the application of a liquidator, to avoid transactions at an undervalue with companies. The proposed look-back period is rather long - five years ending on the commencement of winding up and brings additional uncertainty to derivative transactions and collateral arrangements.
- In relation to a floating charge created by a company for no new value in favour of a connected person, the look-back period for invalidating such a charge is proposed to be extended to two years and the requirement for the company to be insolvent after creation of such a charge is proposed to be removed. These proposals put a charge created in favour of a connected person at greater risk of invalidation to the extent it is not supported by new value.
- Self-contained CO provisions on unfair preferences by companies are proposed to be introduced together with a new wide definition of a "person who is connected with the company".

[1] For more information on the changes being made in the new CO, see our client bulletin on "Twenty five essential things to know about the New Companies Ordinance".

[2] In 2001, the Companies (Corporate Rescue) Bill was introduced into the Legislative Council with a view to introducing a statutory corporate rescue procedure as well as insolvent trading provisions. These proposals did not proceed due to concerns of stakeholders on various employment law related matters and they do not form part of this consultation.

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- As Hong Kong netting or collateral legal opinions typically assume that the transactions are entered into at arm's length and do not involve any element of gift or undervalue from or preference by the insolvent party, these proposed changes will not alter their conclusions but they underline the importance of conducting due diligence to ensure that the assumptions hold true.

Voidable transactions

Derivative practitioners will be particularly concerned about situations where transactions with companies that are or subsequently become insolvent could be avoided by the courts.

Transaction at an undervalue

The proposed introduction of a new "transactions at an undervalue" clawback provision plugs a long-time gap in Hong Kong corporate insolvency law. The proposed new clawback provision brings the corporate regime in line with that of individuals[4] and avoids the need under the present regime to rely on other requirements (such as misfeasance or breach of duty of officer) to challenge these transactions.

A transaction at an undervalue occurs when a company makes a gift or enters into a transaction under which it receives no consideration or consideration the value of which is significantly less than the consideration provided by the company during the look-back period. In addition to covering the situation where the company sells an asset, renders a service or takes on an obligation in return for an under value payment or no payment, this new clawback also covers transactions at an overvalue, such as where the company overpays for property or services. The courts are proposed to have the power, upon application by the liquidator, to restore the position to what it would have been if the company had not entered into the transaction.

The proposed look-back period is five years ending on the commencement of winding up[5]. Although this is in line with the five-year look-back period that applies to transactions at an undervalue by bankrupt individuals under the BO, this appears to be out of line with comparable jurisdictions and other voidable transactions provisions under the CO[6]. A long look-back period brings greater uncertainty to derivative transactions and collateral arrangements as it increases the risk of invalidation by the court.

Where the company has entered into the transaction in good faith and for the purpose of carrying on its business and at the time there were reasonable grounds for believing that the transaction would benefit the company, it is

[4] A similar provision exists in the Bankruptcy Ordinance (Cap. 6 of the Laws of Hong Kong) (the "**BO**") to cover transactions at an undervalue entered into by a bankrupt individual.

[5] But only if the company is unable to pay its debts or becomes unable to pay its debts as a result of the transaction.

[6] The look-back period for transactions at an undervalue under equivalent UK legislation is two years ending with the onset of insolvency. The look-back period for an insolvent transaction which is also an uncommercial transaction under equivalent Australian legislation is two years ending on the relation-back day (extended to four years for related party transactions). The provisions under the CO on unfair preferences, extortionate credit transactions, and floating charges given for no new value have look-back periods ranging from 6 months to three years.

proposed that the court will not set aside the transaction. However, where the transaction is with a person connected with the company, the consultation paper says that there will be a presumption that the company is unable to pay its debts at that time or becomes unable to pay its debts as a result of the transaction. This proposed presumption works differently from the equivalent BO and UK provisions where a transaction with a connected person results in there being a rebuttable presumption of want of good faith (and therefore requires good faith to be proven before one could benefit from the statutory protection). The formulation of the latter presumption seems more intuitively correct because there is no logical connection between the connected person status of the counterparty and the company's lack of solvency.

Statutory protection is also proposed to be extended to a third party (not being a counterparty to the company) who acquires an interest in good faith and for value.

Invalidation of floating charges for no new value created before winding up

The CO currently renders invalid a floating charge created within 12 months of the commencement of the winding up of a company (unless the company was solvent immediately following the creation of the charge) to the extent the charge is not supported by cash paid to the company at the time of or after the creation of and in consideration of the floating charge.

As the existing CO provisions do not distinguish between a floating charge created in favour of a connected person and an independent person[7], the look-back period for a floating charge created in favour of a connected person is proposed to be extended to two years and the requirement to ascertain whether the company was solvent immediately after creation of the charge is proposed to be removed where the chargee is a connected person.

Currently, new value is limited to cash paid to the company. It is proposed that new value will be expanded to include money paid to or at the direction of the company and (although less relevant in the context of security arrangements for derivative transactions) property or services supplied to the company. It is curious to observe that the consultation paper did not mention the inclusion of the value of consideration consisting of discharge or reduction of any debt of the company (which is admissible under equivalent UK legislation). One would have thought that the discharge of a debt owed by the company to the creditor should be recognized as consideration moving from the creditor to the company in the same way as money paid by the creditor to the company.

Unfair preferences

The current corporate insolvency regime in relation to unfair preferences is unsatisfactory as it cross refers to the unfair preferences provisions in the BO which created some anomalies when applied in the corporate insolvency context. The proposal is to tidy up the unfair preferences provision for

[7] A connected person is seen as being more culpable because he can use take unfair advantage of his knowledge of the company's financial position and his influence within the company to improve his position vis-à-vis other unsecured creditors.

corporates by introducing self-contained provisions and a new definition for a "person who is connected with the company" in the CO.

The proposed standalone unfair preference provisions for corporates largely reflect the current provisions under the BO. A "person who is connected with the company"[8] is proposed to be widely defined and follows closely the wording of the equivalent UK definition. The intention is to catch all of those persons whose are part of the company's management or otherwise may be privy to confidential information about its affairs.

How do the proposals affect you?

Whilst the proposed changes in relation to voidable transactions are long overdue and seek to address glaring deficiencies in the present corporate insolvency regime, they will nonetheless increase the risk of invalidation of a derivative transaction or a collateral arrangement if it constitutes a transaction at an undervalue (especially in light of the long five-year proposed look-back period) or a floating charge created in favour of connected parties for no new value. This risk would be brought into sharper focus and would need to be analysed carefully where, for example, in relation to an existing transaction, collateral is substituted for more valuable collateral or additional collateral is provided (although normal mark-to-market top-up arrangements are unlikely to be problematic).

As Hong Kong netting or collateral legal opinions typically assume that the transactions are entered into at arm's length and do not involve any element of gift or undervalue from or preference by the insolvent party, these proposed changes will not alter their conclusions but they underline the importance of conducting due diligence to ensure that the assumptions hold true.

Other proposals

The other proposed changes to corporate insolvency law seek to:

- streamline and minimize the risk of abuse of the procedure for commencement of winding-up by providing for a prescribed form of statutory demand, requiring sufficient notice to members of the directors' initiation of the section 228A procedure, requiring sufficient notice to be given to creditors to prepare for the first creditors' meeting while reducing the time required for a company to commence a creditors' voluntary winding-up, and restricting the powers of a provisional liquidator and a director to those required to preserve the company's assets pending the appointment of the liquidator;
- regulate the size of a committee of inspection, streamline the proceedings of the committee of inspection, facilitate communications by liquidators, and simplify the process for determination of costs of a liquidator's agent in a court winding-up;

[8] The same definition is used for the purposes of the provisions on transactions at an undervalue, unfair preferences and invalidation of floating charges given for no new value.

- expand the provisions on disqualification of provisional liquidators and liquidators, address potential areas of conflicts of interest or duty of provisional liquidators and liquidators, clarify the role of a provisional liquidator in a court winding-up, clarify the court's power to pursue a liquidator's misfeasance notwithstanding release of the liquidator, and allow a liquidator to appoint a solicitor in a court winding-up without sanction of the court or the committee of inspection;
- abrogate the privilege against self-incrimination in a private or public examination before the court in a liquidation investigation and widen the scope of a public examination; and
- where a company is wound up insolvent within a year of a buyback or redemption of shares by payment out of capital, impose liability on the recipients of the buyback or redemption payments and the directors who made the solvency statement without having reasonable grounds for their opinion to pay back amounts not exceeding such payments.

What is to come?

The consultation period for this round of reforms to the corporate insolvency law ends on 15 July 2013. The Government currently plans to introduce an amendment bill into the Legislative Council in 2014/2015.

While these reforms go some way to tooling up the armoury against unfair dealings amongst creditors upon a corporate insolvency, this exercise is by no means complete. Further reforms are on the horizon with the Government planning to reinvigorate the consultation process on a new provisional supervision procedure under a statutory corporate rescue regime and insolvent trading provisions in 2013/2014.

In addition, it should be noted that internationally the focus is no longer on insolvency but on recovery and resolution of financial institutions and financial market infrastructures[9] to ensure that jurisdictions have the authorities and power to effectively implement their resolution regimes for these entities. A report published by the Financial Stability Board in April this year identified a number of areas in which reforms are needed to bring the Hong Kong regime in line with the *Key Attributes*. The report mentioned that authorities in Hong Kong were having internal policy discussions to consider measures to address the shortfalls and that consultations on proposals are expected in the first half of this year. Hong Kong is already lagging behind some other jurisdictions that have set their legislative machinery in motion to align their national laws with the *Key Attributes*. Let us hope that these reforms will come more swiftly than our corporate insolvency law reforms.

[9] The Financial Stability Board published the Key Attributes of Effective Resolution Regimes for Financial Institutions (the "**Key Attributes**") in October 2011 and the consultative document on Recovery and Resolution Planning : Making the Key Attributes Requirements Operational in November 2012. The Committee on Payment and Settlement Systems and the Board of the International Organisation of Securities Commissions published the consultative report on Recovery and Resolution of Financial Market Infrastructures in July 2012.

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