Path Dependence and Durability of Hong Kong's Existing Corporate Reorganization System

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A corporate reorganization system that ensures optimal deployment of distressed companies’ assets helps promote economic development. In many developed economies, faltering firms are reorganized through a formal corporate reorganization procedure. The Hong Kong government has recently recommended the enactment of such a procedure on the assumption that the existing corporate and insolvency framework is ill-equipped to restructure failing companies. This article rebuts this assumption through an assessment of the efficiency of the judicially-developed reorganization system that has emerged as a result of the failure to introduce a formal reorganization procedure a decade ago. It argues that since an efficient alternative reorganization system has been locked in for Hong Kong for more than a decade, a purposely-designed reorganization regime is no longer imperative for this region.

I. Introduction

“Path dependence” is a term that economics and legal scholars use to express the idea that “[w]hat we have today is a result of what has happened in the past”.¹ Once we are put on a path because of certain initial actions, we may find it impossible to leave the path without some cost.² The current form of legal environment on certain matters that has been locked in for given jurisdiction can thus be the result of a decision that lawmakers have made in the past. An example is Hong Kong’s non-purpose-built formal corporate reorganization system, which emerged as the result of a decision made by Hong Kong’s lawmakers in the early 2000s not to introduce a proposed bill on corporate rescue (the initial decision).³ Until the second half of 1990’s, no formal debt reorganization system, purpose-built or otherwise, had been developed in that region and restructuring of distressed companies had largely been effected through informal, contractual means.⁴

³ See infra note 98 and accompanying text.
⁴ See infra note 71 and accompanying text.
Since the second half of the 1990s, when the corporate rescue culture arrived in Hong Kong, a non purpose-built formal reorganization system has been developed in that region by, among others, the courts. This system, which will be termed “the Hong Kong System” in this article, consists of (i) the scheme of arrangement procedure (SOA) and the insolvency law framework provided under Hong Kong’s Companies Ordinance (CO), (ii) the court-made rules on the application of the above-mentioned procedure and framework and (iii) other statutory and common law rules that can be used for reorganization governance purposes.

Due to the 2008 global financial crisis, enacting a reorganization procedure was once again put on the reform agenda. The Hong Kong government made a recommendation in 2009 to reintroduce the corporate rescue bill. The Corporate Rescue Bill that was withdrawn in the early 2000s had been proposed on the basis of some perceptions and predicted inadequacies of an SOA-based reorganization system. The proposal on the reintroduction of the same bill in 2009 was, once again, based on a similar notion. In other words, the views of the proponents of the suggested law reform are largely based on perception or prediction, rather than on proof of any inadequacies of an SAO-based reorganization system. Without such a proof, no accurate assessment on the role or utility of a purpose-built reorganization procedure can be made. The efficacy of the Hong Kong System, which can be expressed as the efficiency of the System, is a touchstone of the “durability” of that reorganization path. This durability, which manifests the society’s inclination to stick to the existing path, defines the role of a parallel reorganization path, if such new path is to be built.

This paper proposes to make an assessment of the efficacy of the Hong Kong System through a study of fifty five reorganization cases decided between 1998 and 2009 by the Hong Kong

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5 1990’s insolvency law reform in Hong Kong started following the introduction of the United Kingdom’s Insolvency Act (IA 1986): Philip Smart & Charles D Booth, Reforming Corporate Rescue Procedures in Hong Kong 1 JOURNAL OF CORPORATE LAW STUDIES 485, 485 (2001). IA 1986, which provided for a number of “rescue procedures” such as Administration, was enacted on the blueprint of the 1986 the UK Insolvency Law Review Committee Report (the Cork report). The Cork report was said to have provided the first formulation of “rescue culture” for the United Kingdom: Muir Hunter, The Nature and functions of a rescue culture, THE JOURNAL OF BUSINESS LAW, Nov. 1999, 491, 49.

6 Infra, note 102 and accompanying text.


8 Financial Services and the Treasure Bureau, Hong Kong SAR, REVIEW OF CORPORATE RESCUE PROCEDURE LEGISLATIVE PROPOSALS: CONSULTATION PAPER 7 (Hong Kong, October 2009).

9 See infra notes 14-16 and accompanying text.

10 Path dependence is present “whenever there is an element of persistence or durability in a decision”: Margolis & Liebowitz, supra, note 1, 18.

11 Including decisions on, inter alia, an application made by the company or stakeholders to stay winding up proceedings or winding up itself (for the purpose of organizing restructuring), and sanction of a proposed SOA reorganization plan. Some of the decisions relate to the different stages of reorganization of the same case.
courts. The reports of these cases were obtained and assembled from the Hong Kong (case) collection of the Westlaw database. These reported cases provide information on the significance of corporate reorganization in Hong Kong, the ways in which formal reorganization has been effected under the Hong Kong System, as well as data that can be used to assess the efficiency of the Hong Kong System.

The efficacy of the Hong Kong System will be assessed in terms of its substantive and procedural efficiency. According to Posner, “A rule is substantively efficient if it sets forth a precept that internalizes an externality or otherwise promotes efficient allocation of resources” and “[a] rule is procedurally efficient if it is designed to reduce the cost or increase the accuracy of using the legal system.” For the purpose of this article, the substantive efficiency of the relevant legal rules is assessed against the ability of these rules to (i) internalize the externality on the proposed reorganization and its participants generated by strategic behaviors of the debtor and claimholders and (ii) promote efficient allocation of the debtor’s assets. The procedural efficiency of the Hong Kong System, on the other hand, is evaluated in the light of the properties of the rules constituting the System in reducing the cost of using that System for the purpose of facilitating corporate reorganization. Efficiency is an appropriate yardstick to assess the efficacy of a reorganization system because the purposes of insolvency rules relate more to efficiency.

This article will prove that the Hong Kong System is substantively and procedurally efficient. It follows that a change of path of the non-contractual mode of reorganization in this region is unlikely to occur even if a formal procedure is put in place. An implication of this conclusion

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12 For example, the existence and nature of going concern value of faltering or faltered companies and the types and number of creditors that a distressed company in Hong Kong typically has.
13 For example, the ways in which a stay can be obtained and a collective decision-making can be reached under the existing statutory framework on the disposition of the debtor’s assets.
14 For example, time used for restructuring different types of distressed companies under the Hong Kong System, as well as the circumstances in which the statutory collective decision-making procedure, for the purpose of effecting an asset sale, can be waived.
16 Id.
17 George G Triantis, Mitigating the Collective Action Problem of Debt Enforcement through Bankruptcy Law: Bill C-22 and its Shadow 20 CAN. BUS. L. J. 242, 242 (1992). To be sure, there are other purposes that an insolvency regimes aims to achieve, such as the often-cited distributional goal of balancing the rights of debtors and creditors. Achievement of the distributional goal, however, is not the predominant purpose of corporate insolvency law. This is because distributional impact that insolvency rules generate between the debtor and consensual creditors is limited because “parties predict the contingent impact of the rules in their earlier dealings” (Triantis id). In any event, the maximization of the debtor’s estate, which can be achieved through efficient insolvency rules, is consistent with the attainment of the distributional purpose of insolvency law.
is that Hong Kong’s reorganization law reform should focus on the improvement of the existing System rather than the enactment of a new procedure.

The remainder of this article is structured into five parts. Part II debates the relevance of corporate reorganization in the Hong Kong context. Part III charts the landscape of corporate reorganization in Hong Kong. Part IV considers the functions of an efficient reorganization system. Part V examines the ways in which the functional roles of a reorganization system are fulfilled under the Hong Kong System. Part VI assesses the efficiency of the Hong Kong System.

II. The Relevance of Corporate Reorganization in Hong Kong

An interesting phenomenon in the global corporate reorganization landscape is that the Hong Kong government has begun its consideration of re-introducing a corporate rescue procedure at the same time when a group of prominent bankruptcy reorganization scholars in North America are questioning the continuing relevance of corporate reorganization in modern societies. This raises a question that must be answered at the outset of this paper, namely, whether the need for corporate reorganization law reform still pertains to Hong Kong. There is no need to debate the most suitable mode of formal corporate reorganization if reorganization itself is no longer relevant.

The proposed law reform in corporate reorganization in Hong Kong is based on a widely accepted rationale behind reorganization. That is that corporate reorganization helps preserve the company or its business as a going concern, as “[g]reater value may be obtained from keeping the essential components together rather than breaking them up and disposing of them in fragments”. The preservation of going concern value potentially benefits a wide range of corporate stakeholders and the community at large.

The strand of scholarship that has thrown doubt on the continuing relevance of corporate reorganization is led by Professor Baird and Professor Rasmussen, who have offered three reasons why corporate reorganization law has become largely irrelevant. First, they argue,

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20 Parry, supra, note 18, 2.
faltering businesses today do not have any going concern value to preserve.\textsuperscript{21} Secondly, reorganization is not the only way to preserve going concern value. A ready market for going concern sales exists today and such sales, through which going concern values are preserved, can substitute for corporate reorganization.\textsuperscript{22} Finally, financial lenders these days are able to discharge the bankruptcy governance function, which used to be carried out by corporate reorganization law, by putting the right person in control of the defaulting debtor through sophisticated contractual techniques.\textsuperscript{23}

Given Baird and Rasmussen’s critiques, is reorganization still relevant in Hong Kong? The answer to this question requires a clarification of the concept of ‘reorganization’ and consideration of whether the reasons provided by Baird and Rasmussen on the irrelevance of corporate reorganization hold true for Hong Kong.

A. The Concept of Corporate Reorganization

The most widely cited definition of corporate reorganization is perhaps the one provided by Jackson, who conceptualizes it as “basically a method by which the sale of a firm as a going concern may be made to the claimants themselves”.\textsuperscript{24} He points out that ‘[t]he key conceptual difference between a reorganization and a liquidation is that in a reorganization the firm’s assets (or most of them) are sold to the creditors themselves rather than to third parties”.\textsuperscript{25} Jackson’s definition has served as the foundation of his views on the need for corporate insolvency law.\textsuperscript{26} Blum, on the other hand, defines corporate reorganization (under the National Bankruptcy Act (US)) as “a process of dealing with the rights of those having


\textsuperscript{22} Baird & Rasmussen, supra, note 21 (\textit{The End of Bankruptcy}), 786.

\textsuperscript{23} Baird & Rasmussen, supra, note 21 (\textit{The End of Bankruptcy}), 782-85. For a critical response to these views see Lynn M LoPucki, \textit{The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen’s The End of Bankruptcy} 56 STAN.L.REV 645 (2003-2004). For the reply from Baird and Rasmussen, see Baird & Rasmussen, supra, note 21 (\textit{Chapter 11 at Twilight}).

\textsuperscript{24} Thomas H Jackson, \textit{THE LOGIC AND LIMITS OF BANKRUPTCY LAW} 211 (1986).

\textsuperscript{25} Jackson, supra, note 24, 21.

\textsuperscript{26} That a sale to existing claimants is a fictional sale and the mechanism for determining the value of the going concern or assets does not exist (Jackson, supra, note 24, 210-13); that the justification for corporate reorganization “must be that the assets are worth more to the claimants themselves than they would be to third parties” (Jackson, supra, note 24, 214). It follows that the baseline protection for claimants is that what the assets could be sold for in liquidation (Jackson, supra, note 24, 215). If that is the case, then the Chapter 11 reorganization process will permit “the claimants as a group to enjoy a larger asset pie than otherwise” (Jackson, supra, note 24, 215); that the benefits of negotiating how to split the surplus obtained by selling the assets back to the claimants instead of third parties is not worth the cost of these negotiations (Jackson, supra, note 24, 215) and that there is a way to ascertain the market value of the failing company’s assets and do away with the need for negotiation between claimants (Mark Roe’s suggestion of issuing 10 per cent of the total stock of the firm, etc (Jackson, supra, note 24, 217).
financial commitments in distressed corporations”.27 A somewhat more expository definition provided by Triantis states that “[b]ankruptcy reorganization is a formal process in which fixed claims are traded for combinations of new claims and ownership interests.”28

Jackson’s definition elucidates very effectively the conceptual difference between liquidation and one important form of reorganization. This definition, however, may not be intended to be conclusive. A feature of Jackson’s definition is that it is formulated by reference to the identity of the purchaser of the debtor’s assets. Read technically, this definition precludes a process that entails a sale to a third party from being characterised as a corporate reorganization. It is doubtful whether this is how Jackson wants his definition interpreted, as he acknowledges in the same work that there may be a mixture of both systems in a given “reorganization”. He points out that “[s]ome of the firm’s assets may be sold for cash. Shares in the reorganized firm may, moreover, be sold to a new investor.” 29 This is exactly what has happened in a significant number, if not most, of the restructurings that have taken place in Hong Kong since the late 1990s. Most of the restructurings that have been arranged in the past two decades or so in Hong Kong have involved a sale of corporate assets to third parties, such as a “white knight”, rather than to existing claimants, without liquidating the debtor company.30 This type of restructuring cannot be described as liquidation, as it does not entail that process. On the other hand, there appears to be no good reason to deny a debt restructuring of this nature the label of “reorganization” just because it does not involve a sale to existing claimants. A consideration of Triantis’ definition confirms this view.

Triantis’ definition, which is consistent with Blum’s, focuses on the alteration of creditors’ claims through the formal process. That definition therefore appears to be more capable of catering for different forms of debt reorganization. For example, Triantis’ definition, in addition to the type of “reorganization” defined by Jackson, covers the type of restructuring in Hong Kong described above, in which case the value of “ownership interests” will be

28 Triantis, supra, note 17, 248.
29 Jackson, supra, note 24, 211, note 4.
30 Of the cases that the author has surveyed, the proposed reorganization plan was sanctioned by the court in 28 cases. Only seven out of these 28 cases involved a sale of a part of the debtor’s assets to existing creditors: Re Kosonic Industries Ltd [1999] HKEC 1183; Re Team Concepts Manufacturing Ltd [2001] HKLRD (Yrbk) 188; Re Wah Nam Group Ltd [2002] HKEC 1090; Re Albatronics (Far East) Co Ltd [2002] 2 HKLRD F6; Re Fujian Group [2003] HKEC 1481; Re Seapower Resources International Ltd [2003] HKEC 1372; Re Ocean Grand Holdings Ltd [2008] HKEC 664.
What existing claimants trade for in that type of restructuring are new claims that do not amount to ownership interests. Triantis’ definition is therefore adopted for the purpose of this paper.

B. Preservation of going concern values through reorganization

The view of Baird and Rasmussen that modern firms have no going-concern value to preserve appears to be based on three alleged facts. First, few firms have firm-specific physical assets that must stay with the firm to preserve the going concern value. Secondly, an increasingly service-based and information-led economy does not require too many hard assets. Finally, intangible dedicated assets are of little value for companies in financial distress.

The reorganization cases that Hong Kong courts have decided since the second half of the 1990s, however, do not appear to fit in the picture that Baird and Rasmussen depicted on the firms’ need for physical assets and the significance of intangible assets for companies in financial distress, although Hong Kong is undoubtedly a service-based and information-led economy.

Of the 55 decisions surveyed for the purpose of this study, 28 fall into the category where the proposed SOA plans were sanctioned (confirmed). The reorganization in seven out of these 28 cases involved the sale of the debtor’s going concerns or physical assets to independent investors. The existence and value of firm-specific assets can be inferred from those investors’ willingness to acquire a debtor’s going concern or part of its going concern, or other tangible assets rather than purchasing bits and pieces from different firms. The going concern value of a business can be preserved even if the firm-specific tangible assets are transferred to another company instead of staying within the old firm.

The above-mentioned cases also reveal that intangible assets, although some of which are not “dedicated”, are of equally important, if not more important, source for obtaining a “net

31 Although there are cases in Hong Kong where creditors’ claims are traded for combinations of new claims and ownership interests (shares in the reorganized company): see supra, note 30.
32 Baird & Rasmussen, supra, note 21 (The End of Bankruptcy), 758.
33 Baird & Rasmussen, supra, note 21 (The End of Bankruptcy), 762.
34 Baird & Rasmussen, supra, note 21 (The End of Bankruptcy), 758.
gain through corporate reorganization in Hong Kong. Seventeen out of the 28 confirmation cases mentioned above involved the sale of intangible assets. Of these 17 cases, only two did not involve the sale of the company’s listing status. One of these entails the sale of the company’s status as a government licensed construction firm. In the other, what the investor acquired was the right to sell products that the debtor company manufactured through a market controlled by the same company.

One of the reasons why investors are willing to ‘purchase’ a company’s listing status lies in the considerable goodwill attached, and the spread of shareholders that, at least in certain cases, goes with it. A further reason is that in Hong Kong, “it has historically been technically easier, if not always cheaper, to take over and revive an existing company by restructuring it and injecting new assets than go for the alternative, a new floatation by way of a new issue or offer for sale.” In Hong Kong, a construction company can only apply for and undertake construction work for the government if it has been licensed to do so. Since the Hong Kong government is the largest provider of construction work in the territory, the right to undertake government projects is an item of valuable property.

Listing status and the status as a government-recognised construction company are not corporate assets for accounting purposes in the sense that they do not appear in the company’s balance sheet. They are, however, legally recognised as the company’s assets. The value of these forms of intangible assets can be preserved only through reorganization, as they will be lost if the company is liquidated. The realization of these intangible assets may

36 The crucial question to be asked in assessing a reorganization regime is “whether there is a net gain to the common pool from proceeding with reorganization instead of a liquidation”: Jackson, supra, note 24, 212.
37 Note that Re Fujian Group [2003] HKEC 1481 entailed the sale of both the company’s listing status and the business of one of its subsidiaries.
38 Re Hong Kong Pharmaceutical Holdings Ltd [2005] HKEC 1593.
40 Smith, supra, note 39, 241.
42 Booth et al, supra, note 41, 312.
43 In Re Plus Holdings Ltd [2007] 2 HKLRD 725, for example, Kwan J approved an application for the appointment of a provisional liquidator on the basis of the need for protecting the company’s assets – its listing status. At the time of the hearing, the Hong Kong Stock Exchange had already announced that the company was put into the third stage of delisting procedures. An appointment of the provisional liquidator may help preserve the company’s listing status as the provisional liquidator may be able to find an investor who is able to make cash injection into the company, in which case resumption of trading of the company’s shares in the financial market may be approved.
44 Smith, supra, note 39.
help a financially distressed company,\textsuperscript{45} or revive its business, or if that is impossible, achieve better returns for its creditors.

C. Does the possibility of going concern sales render corporate reorganization otiose?

There are three different questions to be considered. The first is whether all reorganization entails a going concern sale. The second is whether a ready market for going concern sales renders corporate reorganization unnecessary. The third is whether what needs to be done through a reorganization process can be accomplished outside such a process.

While it is important to recognize that a corporate reorganization is often a corporate assets or going concern sale,\textsuperscript{46} not all reorganizations entail a going concern sale. The funds required for implementing the reorganization, for example, may be contributed by the controlling family or shareholders,\textsuperscript{47} the parent company of a corporate group,\textsuperscript{48} or member companies within a group.\textsuperscript{49} The purpose of the reorganization effort in this situation is often to nurture the company or corporate group back to health. This category of corporate reorganization does not involve a going concern sale. Going concern sales therefore cannot replace corporate reorganization of this type.

To be sure, many corporate reorganization projects in Hong Kong are likely to involve a sale of corporate assets or a going concern.\textsuperscript{50} It may, however, be hard to prove that a ready market for such sales exists in Hong Kong. It is not clear that going concerns or the types of intangible assets referred to previously can be sold straight away through the capital market, as Baird and Rasmussen suggest.\textsuperscript{51} In Hong Kong, as under the US state law,\textsuperscript{52} where the firm being sold merges into the buyer, the buyer takes the firm’s assets together with its liabilities.\textsuperscript{53} A reorganization process is necessary to enable the buyer to take the assets free from the debtor’s liabilities.

\textsuperscript{45}For example through ‘privatize’ the company: Re Albatronics (Far East) Co Ltd [2002] HKLRD (Yrbk) 180.
\textsuperscript{46}Jackson, supra, note 24 at 210-211.
\textsuperscript{47}Re APP (Hong Kong ) Ltd [2004] HKEC 522; Re APP (Hong Kong ) Ltd [2005] HKEC 1583; Re Yetyue Ltd [2001] HKEC 1156.
\textsuperscript{48}Re Sharp Brave Co Ltd [1999] HKEC 368.
\textsuperscript{49}Re UDL Holdings Ltd [1999] 2 HKLRD 817.
\textsuperscript{50}Id.
\textsuperscript{51}Id.
\textsuperscript{52}Id.
\textsuperscript{53}Transfer of Businesses (Protection of Creditors) Ordinance, s 3(1).
As Baird and Rasmussen recognize, straight going concern sales are only possible where the number of creditors of the distressed company is small enough. The problem with firms in Hong Kong is that they tend to have a large number of creditors, which means that the ‘common pool’ problem will arise and a negotiation mechanism is often imperative. This takes us to the next question, namely, whether investors now contract for lender control in the event of insolvency.

D. Can the bankruptcy governance problem be resolved by financial lenders in Hong Kong through the use of contractual techniques?

Baird and Rasmussen believe that corporate reorganization has become obsolete, at least in the US, because investors now contract for lender control in the event of insolvency. They point out that what lies in the heart of corporate reorganization law is the fear that creditors may exercise improperly the power of control which they acquire when the borrower defaults. It follows that a central function of the reorganization law is to ensure the correct match between the incentives of those in control and what is in the best interests of the firm as a whole. The person in control should be a ‘residual owner’ whose interest is identical to that of the firm, such as a senior lender who will not be paid in full. Lenders today are able to put such a person in control in the event of the firm’s insolvency through modern capital structures and contractual techniques, such as adding a term onto the so called ‘revolving credit facility’ agreement, which may give the creditor the power to supplement or even replace company management where default occurs.

Changing control through terms of debt contract may be possible in the US, as most of the legal rules on control rights in that country are default rules, but not necessarily so in Hong Kong. If the central function of insolvency governance is to ensure that the control rights end up in the right hand in rescue situations, then this role has certainly not been taken over by creditors in Hong Kong. First of all, as LoPucki points out, a single residual claimant does

54 Baird & Rasmussen, supra, note 32, 787.
55 Booth, et al, supra, note 41, 310.
56 Baird & Rasmussen, supra, note 32, 779.
57 Baird & Rasmussen, supra, note 32, 780-781.
58 Baird & Rasmussen, supra, note 32, 785.
59 Baird and Rasmussen, supra, note 32, 782-785.
60 Baird & Rasmussen, supra, note 32, 782
not exist in most of the distressed large public companies.\textsuperscript{61} This is particularly true in Hong Kong, where most of the debtor companies have multiple creditors.\textsuperscript{62}

Secondly, the kind of ‘modern capital structure’ and contractual technique described by Baird and Rasmussen may have a role if the lender is a financial institution. A trade creditor normally does not offer sophisticated lending facilities such as a revolving credit arrangement. A feature of corporate finance in Hong Kong is that an insolvent company often has a considerable number of non-bank creditors. In insolvencies in certain type of industries, such as the construction industry, there is often a high percentage of non-bank creditors.\textsuperscript{63} The cases surveyed for the purpose of this study show that a significant portion of lenders who initiated liquidation proceedings are trade, rather than financial, creditors.\textsuperscript{64}

Finally, legal rules on change of control rights under Hong Kong’s Companies Ordinance are mostly mandatory in nature. For example, the provision on creditors’ right to petition for winding up,\textsuperscript{65} which may lead to the replacement of directors with the liquidator, is couched in mandatory terms. So are the provisions on the appointment of a provisional liquidator or a court-appointed receiver,\textsuperscript{66} who will in effect take over company management. These provisions cannot be trumped by contractual arrangements.

Admittedly, it is possible for debenture holders to make control right arrangements through private appointment of receiver or receiver and manager in Hong Kong. Such appointments, however, do not take away the control powers that the Companies Ordinance confers on other classes of creditors. Unsecured creditors, for example, may still commence winding up proceedings.\textsuperscript{67} Creditors with a priority over the charged assets can also take actions against the assets subject to the charge over which a receiver is appointed.\textsuperscript{68} A debenture holder who has the power to appoint a receiver, or a receiver and manager, may well be what Baird and Rasmussen call a “residual owner”. Such a person, however, does not have a monopoly over the control rights unless this person is the only creditor of the company.

\textsuperscript{61} LoPucki, supra, note 59, 662.

\textsuperscript{62} Booth, et al, supra, note 41, 310 (reporting that “in Hong Kong it is almost universally the case that a company will not have just one or two bankers but several (or more)”).

\textsuperscript{63} Booth, et al, supra, note 41, 311.

\textsuperscript{64} Booth, et al, supra, note 41, 311.

\textsuperscript{65} Section 179, CO.

\textsuperscript{66} Sections 166, 168A CO; High Court Ordinance, s 21L.

\textsuperscript{67} Section 179(1), CO. Indeed, unsecured creditors are the more usual winding up petitioners, as secured lenders normally rely on their security: Stephen Briscoe & Charles Booth, Hong KONG CORPORATE INSOLVENCY MANUAL 45 (2nd ed 2009).

\textsuperscript{68} Michael Murray, Keay’s INSOLVENCY: PERSONAL AND CORPORATE LAW AND PRACTICE 475 (6th ed., 2008).
II. The Landscape of corporate reorganization and proposed reform

As pointed out in Part I above, no formal corporate reorganization procedures have been enacted for Hong Kong to date. Restructurings have been achieved through either private workouts (or ‘debt rescheduling’) or the use of insolvency or collective decision-making procedures provided in the Companies Ordinance. The Hong Kong government attempted, without success, to introduce a formal corporate rescue procedure in the early 2000s. The government is currently considering reintroducing a revised version of the same procedure. The following section outlines the specific formal and informal mechanisms that have been used to facilitate restructurings in Hong Kong.

A. Workouts and debt rescheduling

As in many other developed economies, workouts is an important avenue through which a financially distressed company or its business can be rescued in Hong Kong. A workout is “[a]n out of court agreement between the stakeholders of a company on a mutually acceptable course of action, with the aim of rescuing an enterprise with a commercially viable future”. Where such an agreement is with the company’s bank creditors, it is also called a “debt rescheduling”. The purpose of a workout is normally achieved through a compromise made by the creditors on their rights against the debtor company.

The most notable Hong Kong examples of saving distressed companies through debt rescheduling were the rescue of a number of large shipping companies in the 1980s. These companies, including Hutchison Whampoa Ltd; Wah Kwong Shipping and Investment Company (Hong Kong) Ltd, and Oriental Overseas Holdings Ltd, were on the verge of collapse due to the world-wide downturn in the shipping industry in the early 1980s.

The role of workouts in corporate rescues in Hong Kong appears to be significant. According to a survey conducted by Grant Thornton (Hong Kong) on listed companies under debt restructuring in Hong Kong from 1998 to 2004, only 54 percent of the companies surveyed

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72 Lickerish, supra, note 71; D Brown, CORPORATE RESCUE: INSOLVENCY LAW IN PRACTICE 7 (1996).
have attempted to restructure their debts through formal procedures (mainly the s 166 scheme of arrangements). This suggests that 46% of the companies surveyed were reorganized through informal means of debt restructuring.

Generally speaking, workouts are a cheaper means to reorganize as compared to restructuring through formal legal procedures, as the former does not incur the transactional cost for using such procedures. A disadvantage of workouts, however, is that it may be hard or unviable to coordinate where the debtor has numerous creditors, some of whom may be overseas, which is often the case in Hong Kong. This is perhaps one of the reasons for reorganizing through formal procedures.

B. The “Hong Kong Approach”

As a workout is a contractual arrangement, there may be situations where a small number of lenders, sometimes just one, refuse to sign a restructuring agreement and threaten to take action, such as realising security, which would cause the collapse of the proposed workout. To address this problem, the Hong Kong Association of Banks (HKAB) and the Hong Kong Monetary Authority (HKMA) jointly issued a formal, non-statutory guideline called the “Hong Kong Approach to Corporate Difficulties” in November 1999. This document sets out that lenders who are authorised institutions (which are subject to the supervision of HKMA) should be cooperative with a distressed corporate borrower and other lenders in a bid to rescue the company and keep it going, if the company is salvageable. The decision whether to provide continued support to a company is made by the lenders collectively. The role of the HKMA is that of an “honest broker” or impartial mediator to bring workout negotiations to a satisfactory solution. The perception of insolvency practitioners is that the guideline is working well.

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74 Tang, supra, note 73, 113.
76 Interview with Stephen Briscoe Teck Meng Wong, Briscoe & Wong Ltd, Hong Kong, 30 September, 2010.
78 Carse, supra, note 77, 3.
79 E L G Tyler, Insolvency law in Hong Kong in INSOLVENCY LAW IN EAST ASIA 225 (R Tomasic ed., 2006).
C. Receivership

Receivership is a private law remedy “whereby an invariably secured creditor enforces its security against the charged assets of a company”. 80 A receiver can be appointed by the Court or by a secured lender. 81 The basic role of a receiver is to collect, protect and receive property and income from the property charged. A receiver may also be given the power to sell the security and parts of the charged property. 82 Where the charge is over the entire business and undertaking the receiver may be given the power to carry on the business, in which case the receiver will be called a receiver and manager.

The power given to receivers and managers is believed to have contributed to corporate rescue in the United Kingdom:

In some cases, they (receivers and managers) have been able to restore an ailing enterprise to profitability, and return it to its former owners. In others, they have been able to dispose of the whole or part of the business as a going concern. In either case, the preservation of the profitable parts of the enterprise has been of advantage to the employees, the commercial community, and the general public. 83

This view is also held in Hong Kong, where receivers are called ‘corporate doctors’. 84 Apart from organizing the sale of the company’s business as a going concern, a receiver and manager in Hong Kong may achieve the same results for the company or its creditors through, among other things, (i) selling off the unprofitable elements of the business so that the remaining part can be nurtured back to financial health, and (ii) selling the profitable part of the business through a ‘hive off’ to a new company, leaving the old company to be wound up. 85 It is not a rare phenomenon in Hong Kong that a receiver and manager may decide to organize a rescue plan through the statutory procedure of scheme of arrangement. 86

84 Tyler, supra, note 73, 54.
85 J Brewer, THE LAW AND PRACTICE OF HONG KONG COMPANIES 296-97 (2nd ed, 2009); Tyler, supra, note 82, 1262.
notwithstanding the perception that receivers and managers are not incentivized to favour rescue over liquidation.\(^87\)

**D. Scheme of Arrangement**

A Scheme of arrangement (SOA), which is provided in s 166, CO, is a statutorily provided collective decision-making procedure through which the company, its shareholders, and its creditors may reach an agreement on the reorganization of the rights and liabilities of a company’s shareholders and creditors. The aim of an SOA is to obtain a binding agreement among stakeholders, through the operation of the majority rule, on the modification of the legal rights of shareholders and/or creditors. Such modification may or may not be detrimental to the right holder. An SOA can be used for different purposes, such as effecting a capital reduction, redomiciling a company overseas, or reaching a settlement with the creditors.\(^88\)

As a reorganization device, s 166 is perceived to suffer from a number of deficiencies, notably the lack a moratorium provision and the difficulties associated with the organization of class meetings.\(^89\) In fact, since the mid to late 1990s, when a proposed formal reorganization procedure failed to be enacted,\(^90\) s 166 has been used quite extensively as a substitute for the formal restructuring procedure in Hong Kong. The efficacy of SOA as a restructuring device will be considered below.\(^91\)

**E. Section 199 (1) (e) power to compromise**

In normal circumstances, the proper way to distribute the assets of the company other than strictly in accordance with the creditors’ rights is by an SOA under s 166. Under s 199(1)(e), a liquidator has the power to make a compromise or arrangement with the company’s

\(^87\) Finch, *supra*, note 75 et seq.

\(^88\) See also Tyler, *supra*, note 82, 758-760.


\(^90\) *Infra*, section II F (Provisional Supervision).

\(^91\) See *infra*, section V B.
creditors and persons who claim to be the company’s creditors without having to go through the s 166 process.\(^{92}\) This power may also be exercised by a provisional liquidator with the sanction of the court or the Official Receiver.\(^{93}\)

The power to make a compromise or arrangement provided under Section 199 (1) (e), however, can only be exercised to effect a corporate reorganization in special circumstances. Regards must be given to whether the proposed compromise entails an alteration of creditors’ rights, \(^{94}\) the nature of the company’s assets that are subject to the proposed transaction, \(^{95}\) the level of protection that the law needs to provide to creditors in the circumstance, \(^{96}\) and whether a compromise through an SOA procedure would lead to unnecessary costs, significant delay and likely be less advantageous for the unsecured creditors than an exercise of s 199(1)(e) power.\(^{97}\)

### F. Provisonal Supervision

The restructuring procedure that failed to be enacted in Hong Kong in the early 2000s was called “Provisional Supervision” (PS). The law reform on corporate rescue was prompted by the publicity of the corporate turnarounds during the mid-1980s shipping slump mentioned above and the perceived deficiencies of SOA. \(^{98}\) Under the proposal, the PS procedure was triggered by the appointment of a provisional supervisor, who was an independent insolvency specialist. The appointment was to be made by directors. A so-called ‘major secured creditor’, i.e., a creditor holding a fixed charge or a floating charging over the whole or substantially the whole assets of the company, had the right to veto a proposed provisional supervision.

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\(^{92}\) Section 199(1)(e), CO.

\(^{93}\) Section 199 (5), CO.

\(^{94}\) Re Moulin Global Eyecare Holdings Ltd [2007] HKEC 409.

\(^{95}\) A proposed exercise of s 199 (1) (e) power may be viewed favorably where, for example, the transaction in question is one with regard to a single asset rather than the whole sale of the the company assets, especially where the compromise is with one class of creditors only (Re Hong Kong Pharmaceutical Holdings Ltd [2005] HKEC 1593).

\(^{96}\) Thus, a proposed exercise of s 199 (1) (e) power is likely to be sanctioned where most, if not all, creditors are financial or otherwise sophisticated investors (Re Hong Kong Pharmaceutical Holdings Ltd [2005] HKEC 1593); where there has been substantial consultation with the creditors who had been given an opportunity to express their views on a fully informed basis (Re Moulin Global Eyecare Holdings Ltd [2007] HKEC 409), or where there is an overwhelming majority (of creditors) in support of the proposal (Re Moulin Global Eyecare Holdings Ltd [2007] HKEC 409).

\(^{97}\) Re Hong Kong Pharmaceutical Holdings Ltd [2005] HKEC 1593. A typical context where the exercise of a s 199 power has been sanctioned is the reorganization of a corporate group, where there otherwise would have to be separate schemes of arrangements for each of the companies, involving separate applications, which would be costly and time-consuming (Re Moulin Global Eyecare Holdings Ltd [2007] HKEC 409).

\(^{98}\) Tyler, supra, note 79, 219.
Once appointed, the provisional supervisor was to take over the management of the company from the directors. The appointment of a provisional supervisor would trigger a 30-day moratorium automatically, which could be extended to six months by the court. During the moratorium, the provisional supervisor was to make a judgment on the viability of having the company rescued or restructured. If this person’s conclusion was in the negative, the company would go into liquidation. If the provisional supervisor believed the company was salvageable, he or she was to prepare a rescue proposal. The proposal must be approved by a vote of majority in number and 75% in value of creditors present who would vote in one single class. Once the proposal was approved, it would become binding on the company and all of its creditors. The provisional supervisor was, at this point, to hand the power of management back to the directors.

To facilitate the availability of working capital for a proposed rescue, the procedure made a provision for the so-called ‘super priority’. Under this provision, a lender who was willing to provide the funding after the commencement of the provisional supervision was given priority over all other claims, with the exception of fixed charges.

The bill on PS did not make it to the statute book because, among other things, it contained an unrealistic requirement that the company discharge all of its obligations to workers (such as unpaid wages and other entitlements due under the Employment Ordinance) before it could go into Provisional Supervision.99 A company in need of rescue would not have the cash to meet this requirement.

In the late 2009, prompted by the recent global financial crisis, the Task Force on Economic Challenges assembled by the Hong Kong government recommended that the PS procedure be reintroduced in Hong Kong. A three-month public consultation organized by the Hong Kong government on the review of the Provisional Supervision procedure concluded in June 2010. There are two notable features in the “Consultation Conclusions” relating to the stay device and decision-making mechanism under the proposed PS. First, the initial automatic moratorium should be extended from 30 days to 45 working days, as was provided in the failed corporate rescue bill. This automatic moratorium can be extended to a total six months from the commencement of PS with the approval of creditors at a meeting of creditors. Any further extensions can only be granted by the court on application by the provisional

Secondly, the headcount test provided under the previous PS proposal (“majority in number”) is abolished. The government is aiming to reintroduce the procedure to the Legislative Council, Hong Kong’s legislature, in “2010-11”. Given the difficulties that have been experienced in the introduction of the procedure, not everybody is optimistic about the outcome of this law reform project.

IV. The functions of an efficient reorganization system

The ultimate purpose of any corporate insolvency regime is to reallocate the assets of uncompetitive entities. A rapid redeployment of the assets of inefficient firms to higher value uses is conducive to economic growth and helps maximize the resources available for the payment of creditors’ claims. A central task of a corporate reorganization project is therefore to correctly identify the higher value uses and determine how the debtor’s assets should be allocated accordingly.

As a decision on this matter is to be made by creditors collectively, the claimants’ ability to achieve a correct decision may be compromised by self-interested decisions of individual or factions of creditors. A wrong allocation decision will result in an increase on the ex post costs for debt finance (cost incurred after enforcement). An inefficient allocation decision can be caused either by the creditors’ strategic actions such as race to collect or opportunistic behaviour of claimholders within the decision-making process.

Ex post cost can be incurred by the debtor as well where the reorganization process is under the control of debtor management. The agency problem tends to be exacerbated during corporate reorganization. Generally speaking, the interests of management are more aligned with that of the shareholders than with creditors. During reorganization, the debtor’s assets belong to creditors. Disloyal or strategic conduct on the part of debtor management may

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result in an incorrect allocational decision or a reduction of the pool of assets available to the creditors.

A reorganization system therefore will be efficient if it facilitates the making of an accurate allocational decision and helps preserve the debtor’s assets during reorganization through controlling strategic behaviour on the part of both the debtor and its creditors. These functions can be fulfilled through three different procedural or doctrinal mechanisms. The first of these is a stay mechanism to stop creditors from taking enforcement actions. Corporate reorganization entails an adjustment of the rights and obligations of different stakeholders, which takes time. In the mean time, company creditors tend to exercise their individual remedies against the company when the company is unable to meet the debts owed to all of its creditors. A race to collect, when the company is in a rescue situation, will generate negative externality on the creditors as a whole. It does this so through, among other things, dismembering the company and thereby denying the claimholders, as a collective entity, the opportunity to deliberate on the allocation of the debtor’s assets, which may result in a wrong decision on the deployment of the debtor’s assets.

The second is collective decision-making mechanism that ensures the correctness of the creditors’ allocational decision through controlling inter-creditor strategic behaviours. The need for a formal decision-making procedure can be seen from the susceptibility to strategic behaviour of informal methods of reorganization. As discussed in part III A above, it is possible for claimholders, especially those who are financial lenders, to make an allocational and distributional decisions outside the statutory insolvency system through debt rescheduling or workouts. A decision made through a workout, however, must be made on the basis of unanimous consent. A unanimous consent, however, can be hard to achieve. A recalcitrant claimant, for example, may decide to veto a plan in order to hold out for another plan which is more favourable to itself. To resolve the hold out problem, it is necessary to provide for a collective decision-making mechanism to bind dissenters.

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107 Jackson, supra, note 24, 10-11.
108 This means “[s]imultaneous individual actions by different creditors in order to be paid by the company in financial difficulties, at the expense of the others”: J A A Adriaanse, Restructuring IN THE SHADOW OF THE LAW: INFORMAL REORGANIZATION IN THE NETHERLANDS 176 (2005). On the effect of such a race, see Jackson, supra, note 24; Brain R Cheffins, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 546-547 (1997).
109 Quinn, supra, note 104, 3; Tyler, supra, note 82, 758.
110 Triantis, supra, note 17, 246.
A collective decision-making process designed to bind dissenters necessarily operates on the majority rule principle. A poorly designed decision-making mechanism, however, can be used by opportunistic claimants to their own advantage at the cost of the collective interest of all the claim holders. Creditors whose interests are consistent with the continuing existence of the debtor (those who have a “collateral relationship” with the company), for example, may impose an inefficient reorganization on senior creditors or those who do not have any collateral stakes in the survival of the company. Creditors with small claims may have an incentive to approve a risky reorganization, the risk of which will be borne by creditors with large claims.111

On the other hand, creditors of different seniority under a distribution scheme or those who do not have a collateral stake112 within a given seniority class may credibly threaten to block a value-maximizing reorganization unless they are paid a bribe from the rightful share of creditors of a different class under the statutory distribution regime or of claimants who do have a collateral stake.113

The third mechanism that a reorganization system must provide is procedural and doctrinal structures that protect the creditors’ interests from the overreaching activities of debtor management. When a company is on the verge of insolvency or is in a reorganization process, the management and shareholders may have a stronger incentive to transfer assets to themselves at the expense of creditors. Wealth transfer can be achieved through excessive asset distribution to shareholders or managers; assets substitution, whereby the management takes excessive investment risk; and management entrenchment through suboptimal investments.114

Assets distribution can take the form of excessive salaries, interest-free loans, or excessive dividends.115 Wealth transfer can also be effectuated through the use of the managers’ discretion over investment decisions “to wrest concessions from the firm’s creditors by threatening to sap firm value through suboptimal investment policies”.116 Management

112 That is, claimants who do not have an interest in the survival of the company.
113 Quinn, supra note 104, 3-4.
115 Buckley, supra, note 103, 745.
shirking can also have the effect of wealth transfer. A firm with outstanding debt will have an incentive to forego future investment opportunities if the benefits accrue to bondholders rather than shareholders. The benefits of future investments will accrue to creditors when the company is in a rescue situation, where managers are really hired at the cost of creditors. By foregoing investments for the benefit of creditors whilst being paid by creditors, the managers transfer wealth to themselves at the expense of creditors.

The incentive of engaging in asset substitution lies in the fact that (i) an increase in the level of risk taken lowers the price at which the credit was obtained, if the price reflects both the cost of capital and the risk of default, and (ii) any upside gains from the risky investments favour the shareholders and downside losses are shared by the creditors. While the need for future capital may discourage the company to adopt this strategy, this conduct is rational where the company faces insolvency.

The purpose of preserving management’s own positions can be achieved through resisting an efficient liquidation or making value decreasing investments in which they have expertise to make themselves indispensible to the firm. The managers may also achieve their self-preservation through misusing the formal reorganization system itself. For example, managers may choose to burden their firms with “too much” debt or “impossible” debt-payment obligations to avail themselves of insolvency protection. They may use the reorganization regime as a stalling tactic or a means to obtain a ‘debt holiday.’ The formal reorganization system has even been used as a litigation tactic to stay winding up proceedings and legal actions against the company.

Given that the residual claimants are creditors when the company undergoes a reorganization process, debtor overreaching activities considered above are, in essence, manifestations of typical agency problems. The directors are now functioning as agents of the creditors. The

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117 Burgman & Callen, supra, note 116, 137.
119 Buckley, supra, note 114, 745; Trebilcock & Katz, supra, note 114, 8.
120 Grantham, supra, note 118, 66.
121 Buckley, supra, note 114, 745-746. See also Posner, supra, note 111.
negative externality that wealth transfer generates includes the reduction of the size of the ‘pie’ that belongs to the right-holders, and the fact that debtor opportunism may result in a wrong decision on the allocation of the debtor’s assets (e.g. when directors resist a value-maximising reorganization or misuse the reorganization procedure to avoid or delay an otherwise efficient liquidation).

V. The fulfilment of the functions of an efficient reorganization regime under the Hong Kong System

A. Achievement of a moratorium

The need for a stay is met in the United States by providing an automatic stay under the Bankruptcy Code. In contrast, section 166, the SOA provision under the CO, does not provide for an automatic stay. The lack of such an automatic stay provision, however, does not mean that no stay of proceedings can be achieved under the CO to facilitate reorganization. First, the CO does provide a stay of proceedings where a winding-up order has been made or a provisional liquidator has been appointed. Secondly, a stay can be effected by a court through an exercise of some of its statutory powers in relation to winding up administration, such as the powers to adjourn winding-up petitions and to appoint provisional liquidators.

The relevance of an automatic stay triggered by a winding up order is that the issuance of such an order, while signalling the commencement of liquidation process, does not necessarily exclude the possibility of reorganization. In fact, in Hong Kong, a restructuring plan can be devised or carried out after a winding up order has been made against the company. It is quite common in Hong Kong for potential investors to approach the

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125 The Bankruptcy Code §362.
126 Companies Ordinance, s 186.
127 Companies Ordinance, s 180 (1).
128 Companies Ordinance, s 193. Section 181 of the CA also gives the courts the power to stay or restrain pending proceedings against the company. This provision has been used to prevent a creditor from gaining priority over others where a petition has been made which might result in a winding up or scheme of arrangement (Attlee Investments Ltd v Lee Chuen [1982] HKLR 420).
129 The restructuring plans in seven of the 55 s 166 restructuring cases that have been reviewed for the purpose of this study (i.e., about 17% of these cases) were initiated/organized by liquidators of the companies in liquidation: Kansas General International Insurance Co Ltd [1999] 2 HKLRD 429; Re Yaohan Hong Kong Corp Ltd [2001] 1 HKLRD 363; Re Akai Holdings Ltd [2002] HKEC 1365; Re Albatronics (Far East) Co Ltd [2002] HKLRD (Yrbk) 180; Re Wah Nam Group Ltd [2002] HKEC 1090; Re Moulin Global Eyecare Holdings Ltd [2007] 4 HKLRD 363; Re Dickson Group Holdings Ltd [2008] HKEC 899; Re Zhu Kuan (Hong Kong) Co Ltd [2007] HKEC 1947.
liquidators with restructuring proposals after a winding-up order has been made.\textsuperscript{130} Alternatively, a liquidator may take the initiative to find potential investors and put forward to them a rescue proposal.\textsuperscript{131} A liquidator, for example, may prepare and distribute an information package to investors to invite proposals for restructuring so as to realize the listing status and other core assets of the company or group.\textsuperscript{132} Where a restructuring was initiated before the commencement of liquidation administration (by the Provisional Liquidator, for example), the liquidators may decide to carry on and complete the restructuring plan after the winding-up order is made.\textsuperscript{133}

The appointment of a provisional liquidator and an adjournment of a winding up petition activate a stay through suspending the liquidation process. An appointment or an adjournment order is made largely through the exercise of the court discretions, the exercise of which must be guided by specific rules. Since the mid to late 1990s, a set of sophisticated rules on the exercise of the courts’ adjournment and provisional liquidator appointment powers have been developed through the courts’ adjudication of a large number of corporate reorganization cases. The remainder of this section considers the content and effect of these rules.

\textbf{(a) Adjournment of winding-up petitions}

On most occasions where the court is asked to sanction an SOA for a reorganization purpose, a winding-up petition would have already been made against the company. An order to adjourn a winding-up petition gives the company a respite during which the viability of a restructuring scheme can be considered and (in some cases) a rescue plan can be prepared.

A complex restructuring project is likely to require more than one adjournment.\textsuperscript{-} In making decisions on the grant of adjournments, the court needs to be guided as to (i) the circumstances in which, (ii) the conditions under which, and (iii) the duration of which, the initial and subsequent adjournments can be granted for reorganization purposes.

\textsuperscript{130} For example, \textit{Re Kansa General International Insurance Ltd [1999] 2 HKLRD 429; Re Sharp Brave Co Ltd [1999] HKEC 368; Re Akai Holdings Ltd [2002] HKEC 1365.}

\textsuperscript{131} For example, \textit{Re Dickson Group Holdings Ltd [2008] HKEC 899.}

\textsuperscript{132} For example, \textit{Re Wah Nam Group Ltd (No 2) [2003] 1 HKLRD 282.}

\textsuperscript{133} [1999] HKEC 637 (Pinpoint reference unavailable).
**Initial adjournment**

The purpose of an initial adjournment is to enable the debtor company to consider the viability of a restructuring. Jones J expressed the view in *Re X10 Ltd*¹³⁴, that a period in the vicinity of four weeks would be sufficient to enable the company to make this assessment.¹³⁵ His Lordship recognized that there might be circumstances that justify longer adjournments or more than one adjournments.¹³⁶ The four-week rule that Jones J formulated was endorsed in the subsequent Court of Appeal case *Re Esquire (Electronics) Ltd* (Re Esquire).¹³⁷

**The possibility of further adjournments**

A successful restructuring invariably requires more than one adjournment. Once the court is convinced that a restructuring is viable, more time will be needed to implement the proposed scheme. As Le Pichon J pointed out in *Re UDL Holdings Ltd*,¹³⁸ the four-week rule mentioned above should not be taken to be an inflexible rule. If the company considered that an alternative of a winding-up was possible and the proposed alternative had the support of the creditors or a substantial majority of them,

“it must follow that such adjournments as may be necessary should be granted until the creditors are able to decide whether or not to accept the alternative arrangement by voting at any court convened meeting. Otherwise the short adjournment would not serve any useful purpose given the procedure involved in a s 166 application”.¹³⁹

**Prerequisites for further adjournments**

To grant a further adjournment, the court needs to be convinced that two criteria are satisfied. First, the proposed restructuring scheme must have the ‘in principle’ support of the majority of creditors (the ‘in-principle’ support criterion). Second, it must be reasonably arguable that the majority of participants would support and the court would sanction the proposed scheme (the viability criterion).¹⁴⁰

The ‘in-principle support’ criterion entails an examination on the size of creditors’ support for the proposed scheme. That notwithstanding, no specific rules appear to have been

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¹³⁴ *Re X10 Ltd* [1989] HKLR 306 HC.
¹³⁵ *Re X10 Ltd* [1989] HKLR 306 HC per Jones J at [3].
¹³⁶ *Re X10 Ltd* [1989] HKLR 306 at [3].
¹³⁷ [1996] HKLY 203 CA.
¹³⁸ *Re UDL Holdings Ltd* [1999] 2 HKLRD 817 at 822-823.
¹³⁹ *Re UDL Holdings Ltd* [1999] 2 HKLRD 817 at 823.
¹⁴⁰ *Re APP (Hong Kong) Ltd* [2004] HKEC 522.
formulated on the type of majority that must be proven in establishing the creditors’ ‘in
principle’ support. What is clear is that in virtually all of the cases where subsequent
adjournments were granted, the companies in question were able to prove that the proposed
scheme had the ‘in principle’ support of three-fourth (or thereabouts) in value of the
creditors.141 This suggests that the supra majority required for the sanction of a s 166 proposal
(“a majority in number representing three-fourths in value of the creditors, etc”) has been
used as a guide to determine whether the ‘in principle support’ requirement, for the purpose
of considering an adjournment petition, is met. According to Le Pichon J, an adjournment is
only justified if a restructuring proposal is shown to have the necessary ‘in principle’ support
within the few weeks of the first hearing.142

The content of the viability criterion may differ slightly depending on the nature and purpose
of a proposed restructuring scheme. Where the proposed restructuring scheme entails a sale
of assets to an independent investor, the viability of the scheme is assessed by comparing the
position of the (normally unsecured) creditors in a restructuring scenario with that in a
liquidation situation. A proposed scheme is generally regarded as viable if the proposed
scheme will result in a better return for scheme creditors when compared with their position
in the scenario where the company is to be liquidated.143

Where the proposed scheme aims at rehabilitating the company, at least where the estimated
liquidation recoveries for unsecured creditors would be practically zero, the in principle
support of the proposed scheme by a large number of creditors may be a ipso facto a
sufficient reason for granting an adjournment. This is especially so where the creditors in
support of a rescue scheme are mostly financial creditors which have made their commercial
decisions on the strength of a liquidation analysis prepared by a liquidation/corporate
recovery specialist.144

141 Re Advanced Wireless Group Ltd [2007] HKEC764; Re APP (Hong Kong) Ltd [2004] HKEC 522, and Re
CIL Holdings Ltd [2002] HKEC 97; Re UDL Holdings Ltd [1999] 2 HKLRD 817.
142 Re Hong Kong Brewing & Restaurants Ltd [1999] HKEC 637 (pinpoint reference unavailable).
143 Re Advanced Wireless Group Ltd [2007] HKEC764 (liquidation scenario: in the range of 1.68 % and 3.01%,
restructuring scenario: in the range of 9.99% and 16.52%); Re APP (Hong Kong) Ltd [2004] HKEC 522
(liquidation scenario: in the range of 2.6% to 4%; restructuring scenario: immediate 10% return or one new
share of par value HK 1 for every HK 1 of their admitted claims, such shares ranking pari passu to the existing
shares).
144 Re UDL Holdings Ltd [1999] 2 HKLRD 817 at 828 per Le Pichon J.
Duration of further adjournments

The duration of each of the subsequent adjournments varies between one week to three months.\textsuperscript{145} A complex restructuring process may require a stay for a total period of close to two years.\textsuperscript{146} The courts in Hong Kong have shown a willingness to grant multiple adjournments to accommodate this need.\textsuperscript{147} Subsequent adjournments have been granted to enable the company to (i) conduct negotiations with potential investors, (ii) have a liquidation analysis prepared by a corporate recovery/liquidation specialist, (iii) put a restructuring proposal to its creditors and to ascertain the creditors’ views, (iv) prepare scheme documents and (v) to make an application to convene creditors’ meeting to vote on the scheme.\textsuperscript{148}

(b) Provisional liquidation

Section 193 of the CO gives the court the power to appoint a liquidator provisionally after the presentation of a winding-up petition and before the making of a winding-up order.\textsuperscript{149} Such an appointment, according to s 192, must be “for the purpose of conducting the proceedings in winding up a company and performing such duties in reference thereto as the court may impose”.\textsuperscript{150} As mentioned previously, the appointment of a provisional liquidator triggers an automatic stay of proceedings against the company.\textsuperscript{151}

The traditional common law position on the appointment of a provisional liquidator was that such an appointment could be made to protect the company’s assets pending the outcome of the winding-up petition, to maintain the status quo, and to prevent any creditor from gaining priority.\textsuperscript{152} The modern position, however, appears to be that the appointment of a provisional

\textsuperscript{145} In Re Advanced Wireless Group Ltd [2007] HKEC 764, the company was granted a number of adjournments between October 2006 and July 2007. The shortest adjournment granted was a week (see [4] in the judgment). The longest, three months (see [53]).

\textsuperscript{146} For example, in Re CIL Holdings Ltd [2003] HKEC 519, the winding up petition was presented on 11 May 2001 and the proposed scheme was sanctioned on 2 April 2003. The total period of stay granted through extending adjournments amounted to close to 23 months.


\textsuperscript{149} Section 193, CO.

\textsuperscript{150} Section 192, CO.

\textsuperscript{151} Section 186, CO.

liquidator does not have to be restricted to the above-mentioned purposes. Megarry VC observed in *Re Highfield Commodities Ltd*\(^{153}\) that there was no hint in the UK equivalent of s 193, CA that an appointment of a provisional liquidator must be restricted to certain types of cases.\(^{154}\) In the abovementioned case, Megarry VC refused to remove the provisional liquidator appointment by the Secretary of State made to protect members of the public from the alleged frauds of the company.

The less restricted position set out by Megarry VC appears to have ushered in an era, which ended in 2003, during which provisional liquidation was used to achieve moratoria for financially distressed insurance companies in the UK. Prior to the enactment of Enterprise Act 2002 (UK), provisions for Administration contained in Part II of the Insolvency Act 1986 (UK) did not apply to insurance companies. During that period, the courts had developed the practice of using a winding-up petition as the basis for the appointment of provisional liquidators to resolve financial difficulties by an SOA under s 425 of the Companies Act (UK) 1985.\(^{155}\) This practice has been dealt with and has been approved by judges of different courts.\(^{156}\)

The creative use of provisional liquidation to obtain moratoria in England has inspired courts to do the same in a wider context in Hong Kong. There is no space to outline in this article the development of the jurisprudence by Hong Kong courts on provisional liquidation as a stay device. It is, however, necessary to mention the recent twist on the development of the law on provisional liquidation in Hong Kong. This twist is cause by an *obiter dictum* in Kwan J’s judgment in *Re Legend International Resorts Ltd*,\(^{157}\) the case of which represents the high water mark on the creative use of provisional liquidation in the context of reorganization in Hong Kong. Kwan J’s stated in that case that it was within the jurisdiction of the court to appoint provisional liquidators to explore, formulate and pursue a corporate rescue.\(^{158}\)

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\(^{39}\) Ch D 306 per Kay J at first instance; *Re Hammersmith Town Hall Company* (1877) 6 Ch D 112; *Re Carpark Industrial Pty Ltd* [1967] 1 NSWR 337, 341.

\(^{153}\) [1985] 1 WLR 149.

\(^{154}\) *Re Highfield Commodities Ltd* [1985] 1 WLR 149 at 159 C-F.


\(^{157}\) [2005] 3 HKLRD 16 CFI.

\(^{158}\) *Re Legend International Resorts Ltd* [2005] 3 HKLRD 16 at 49.
Kwan J’s statement, which Rogers V-P described as ‘bold’ in His Lordship’s appeal judgment, caused an apparent backlash on the use of provisional liquidation as a reorganization device in Hong Kong. In his judgement, Rogers V-P stressed the difference between the appointment of a provisional liquidator on the basis that the company was insolvent and that its assets were in jeopardy and an appointment solely for the purpose of enabling a corporate rescue to take place. His Lordship held that the power to appoint provisional liquidators was provided for under s 192, CA, which stated that the appointment of a provisional liquidator must be for the purpose of winding-up, rather than avoiding winding-up, of a company.

Rogers V-P’s comment in Re Legend appears to have sent out a negative message on the use of provisional liquidation as a reorganization device. The Consultation Paper on corporate rescue procedure prepared by Hong Kong’s Financial Services and the Treasury Bureau in 2009, for example, justifies the need for enacting a formal rescue procedure on the basis that, *inter alia*, Rogers V-P’s judgment in *Re Legend International Resorts* has put in place some limitations on the use of provisional liquidation procedures for rescue purposes.

In fact, the impact of the Court of Appeal’s decision in *Re Legend International Resorts* on the use of provisional liquidation as a restructuring device has perhaps been somewhat overstated. Rogers V-P’s view on Kwan J’s ‘bold’ statement referred to previously was made by way of *obiter dicta* only. The difference that His Lordship noted between (i) the appointment of a provisional liquidator on the basis that the company is insolvent and that its assets are in jeopardy and (ii) an appointment solely for the purpose of enabling a corporate rescue to take place is, in any case, insignificant. As His Lordship himself noted: “[t]he difference, may, in most cases, be merely a matter of emphasis”. Generally speaking, there is no need for devising a corporate rescue scheme when the company is solvent. At least where the proposed restructuring scheme involves a sale of assets to an independent third party, a need for preserving the assets to be sold is self-evident. It would not be difficult to meet the protection of assets requirement in most cases. A telling post-*Legend* example is *Re*
Plus Holdings Ltd,\textsuperscript{164} where Kwan J held that an appointment of provisional liquidators was essential for the preservation of the company’s listing status, which could be sold to a third party investor, should the proposed restructuring succeed. In that case, the provisional liquidators have successfully devised a restructuring by an SOA, which was sanctioned by the court.\textsuperscript{165}

As to the need for satisfying the s 192 requirements, winding up and restructuring are not always mutually exclusive. In fact, Rogers V-P’s comment that a restructuring is but an alternative to winding up itself is somewhat “bold”. Typical restructuring methods used in Hong Kong, it will be remembered, include (1) the selling of the entire business of the doomed company as a going concern instead of selling assets piecemeal, and (2) the selling of the profitable part of the business through a ‘hive off’ to a new company, leaving the old company to be wound-up.\textsuperscript{166} Both of these types of rescue measures are entirely consistent with the purpose of s 192 in that they are not aimed at “avoiding winding-up”, nor are they alternatives to winding-up. The old company in both scenarios is to be wound up. Most of the restructuring schemes do not aim at rehabilitating the company.\textsuperscript{167} It can therefore safely be predicted that the views that Rogers V-P expressed in Re Legend on the appointment of provisional liquidators for reorganization purposes will not prevent provisional liquidation from being used to trigger a stay to facilitate a proposed reorganization.

B. Policing strategic behaviors of scheme participants

The main decision-making mechanism that the CO provides is the SOA provision under s 166, mentioned above. This provision protects creditors through its voting rules and the control power it confers on the courts over the procedure. The rules that the courts have developed on the application of this provision help fill the gaps left in this SOA provision. The remainder of this section will start with a brief outline of the decision-making mechanism provided under s 166. It then proceeds to consider anti-opportunism properties of the SOA procedure (including the judicially developed rules on the application of SOA) and

\textsuperscript{164} [2007] 2 HKLRD 725.
\textsuperscript{165} Re Plus Holdings Ltd [2008] HKEC 1327.
\textsuperscript{166} Brewer, supra, note 85, 296-97; Tyler, supra, note 82, 1262.
\textsuperscript{167} Finch, supra, note 87, 243.
other statutorily provided creditor protection mechanisms. The creditor protection effect of the above-mentioned statutory mechanisms will be considered in the light of the need for protecting creditors against (i) inter-creditor rent-seeking behaviours, (ii) intra-creditor strategic behaviours, and (iii) debtor opportunism.

(a) The SOA regime under s 166

As noted above, s 166 is the only provision in the CO that provides a procedure by which company creditors are able to reach an agreement to bind themselves *inter se*, and to the company, by a prescribed level of majority, to accept the terms of the proposed compromise plan. The required level of majority prescribed under s 166 resembles that stipulated in § 1126, Chapter 11 of the US Bankruptcy Act, namely a majority in number representing three-fourths in value of the creditors or class of creditors, or members or class of members.

Upon court sanction, the scheme will be binding on any dissenting minority, who may otherwise seek to wind up the company before the completion of a reorganization plan. A proposal made under Hong Kong’s s 166 cannot be sanctioned unless it is approved by each class through decisions made in their own class meetings. This requirement is perceived as one of the difficulties relating to that provision. To confirm a Chapter 11 plan, by way of contrast, there is no need for obtaining the approval by each class of claims. The only limitation on the court’s power of confirmation is that the court cannot confirm the plan unless it has the approval of at least one class of impaired claims.

The rationale behind the requirement of class meetings is to prevent the collective decision-making procedure from being exploited by strategic actors to benefit themselves at the expense of other scheme participants. A sticky issue that courts in different jurisdictions have experienced in exercising their discretion in implementing a collective decision-making procedure is the ways in which a class should be constituted. It appears to be widely

168 On the rules on the sanction of a proposed s 166 scheme, see *infra* notes 202-207 and accompanying text.
169 Tyler, *supra*, note 82, 761.
170 Tyler, *supra*, note 82, 761.
171 The United States Bankruptcy Code, §1129 (a) (10).
172 *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 at 583 per Bowen LJ. Lopucki & Triantis, *supra*, note 24, 171. See also the discussion below on the role of class meeting in controlling creditor opportunism against fellow creditors: *infra* note 191 and accompanying text.
173 *Supra*, note 89.
believed that the lack of clear rules on classification renders SOA too complicated a restructuring instrument to deploy.\textsuperscript{174}

As far as Hong Kong is concerned, the assessment on the utility of SOA mentioned in the preceding paragraph has not been borne out in reality. The truth is that courts in Hong Kong have developed a set of classification rules that have proven to be effective. This set of rules comprises two different rules. The first one, which can be termed the “common right” rule, says that SOA scheme participants are to be classified by dissimilarity of claim holders’ rights against the company, not dissimilarity of their individual interests.\textsuperscript{175} The second one, which can be called the “exclusion rule”, states that members or creditors whose interests are not to be affected by the proposed scheme do not need to participate in the scheme.\textsuperscript{176}

In addition to providing guidance on classification, the common right rule and the exclusion rule perform two further functions. First, they resolve the difficulty associated with the requirement that a proposal be approved by each class of claims. A result of the application of the rules is that, in most cases, only a single class of claimholders needs to participate in the proposed scheme.\textsuperscript{177} Secured creditors and preferential creditors, for example, often only need to participate in their capacity as ordinary unsecured creditors to the extent that their claims are not met under the proposal.\textsuperscript{178} Secondly, and more importantly, the rules have proven to be effective instruments to discipline strategic behaviours. This will be elaborated in the discussion below.

(b) Policing inter-creditor opportunism

Broadly, stakeholders’ interests may be harmed by two types of inefficient decisions in the disposition of the debtor’s assets. The first is the imposition of a non value maximizing

\textsuperscript{174} Finch, supra, note 87, 483 and accompanying text. See also Tyler, supra note 84, 55-56; Smith, supra, note 39, 245; P Smart & C D Booth, Reforming corporate rescue procedures in Hong Kong 1 JOURNAL OF CORPORATE LAW STUDIES 485, 487 (2001) (“the deficiency of the scheme of arrangement as a corporate rescue mechanism require no elaboration”); C D Booth, Hong Kong insolvency law reform: preparation for the next millennium THE JOURNAL OF BUSINESS LAW (2001) 126, 147-148; Booth et al, supra, note 41, 300-01.

\textsuperscript{175} In re Industrial Equity (Pacific) Ltd [1991] 2 HKLR 614; UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin [2001] HKEC 614.

\textsuperscript{176} Thus where the proposed scheme involves a compromise with creditors who have recourse against both the borrowing company and the guarantor, which was the parent company of the borrower, it is unnecessary to include creditors who have recourse to the borrower but not the guarantor: Re Jinro (HK) International Ltd [2004] HKEC 519.

\textsuperscript{177} This is the position in all but one case where the proposed schemes have been sanctioned by the Hong Kong courts since the 1990s. The only case where more than one class meetings were required is Re Plus Holdings Ltd [2008] HKEC 1327.

\textsuperscript{178} For an example, see UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin [2001] HKEC 1440.
reorganization on dissenting stakeholders. The other is the blocking of an efficient reorganization proposal.

The incentive for forcing an inefficient reorganization on other stakeholders comes from what Quinn calls “collateral interests.”\textsuperscript{179} The interests of certain categories of claimants are consistent with the continuing existence of the company. They include company officers and employees, as well as suppliers and trade creditors. The liquidation of the company means that they will lose a valuable source of income. This category of creditors may therefore be induced to vote for a reorganization proposal even though the value of their expected return is likely to be increased if the company is liquidated.\textsuperscript{180} It is possible for a non-value maximizing reorganization to be imposed on a certain \textit{class} of claimants (such as secured creditors) by another \textit{class} of claimants (who tend to be junior creditors), in which case the conflict is between members of different classes.

Where the statutory decision-making mechanism requires the approval by claimants of different classes through class meetings, it is also possible for members who have collateral interests to force their will on members who do not within the same class. Where the conflict is intra-class, the difference in the size of stakes held by each claimant gives small claim holders more voting power than they are entitled to, if voting is conducted on a head count basis. Small claim creditors, for example, may be willing to support a risky reorganization proposal if they could compel a minority of large claim holders to contribute most of the capital.\textsuperscript{181}

A decision to block a value maximizing reorganization can be motivated for two different reasons. The first is the reverse of “collateral interests”. A category of claimants may prefer immediate liquidation to the reorganization option because, at least according to their own understanding, they would be financially better off if the company is immediately wound up.\textsuperscript{182} The second is the desire to bargain for a share of the debtor company’s assets that the claimant is not entitled to under the statutory distribution system, which requires, generally speaking, that the claims of senior claimants be met before that of the junior claimants.\textsuperscript{183} Either junior or senior claimholders, for example, may threaten to block an efficient

\textsuperscript{179} Quinn, \textit{supra}, note 109, 4.
\textsuperscript{180} Quinn, \textit{supra}, note 109, 4. See also Baird, \textit{supra} note 89, 327.
\textsuperscript{181} Quinn, \textit{supra}, note 109, 24.
\textsuperscript{182} As in \textit{UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin} [2001] 3 HKLRD 634.
\textsuperscript{183} Quinn, \textit{supra}, note 109, 4.
reorganization plan unless they are paid a premium.\textsuperscript{184} Part of the incentive for small claim creditors to hold out to extract a bribe is that they, in any event, will have little to lose from an inefficient disposal of the debtor’s assets, as stated previously.\textsuperscript{185} As in the case of forcing through an inefficient reorganization, a hold out threat can also be made against the claimants of either creditors of a different class or claimholders within the same class. Where a hold out is aimed at claimants within the same class, unequal stakes, as stated above, can be used as a device to obtain positional advantage.

As pointed out in part IV, one of the roles of a reorganization decision-making mechanism is to protect stakeholders from the strategic behavior of other creditors. In Hong Kong, the statutory SOA regime, which functions in conjunction with other corporate insolvency instruments, as well as court-developed s 166 jurisprudence, has proven to be effective in curtailing both type of strategic behaviours considered above. This can be more clearly illustrated through a consideration of the effect of the statutory and court-developed rules on the various types of inter and intra class strategic behaviors.

\textbf{Inter class opportunism}

In the United States, inter-class opportunism is controlled chiefly by the courts’ power to cram down\textsuperscript{186} a plan on a class that votes against it.\textsuperscript{187} The courts can do so on a finding that the plan is fair and equitable to the class and does not discriminate the class unfairly.\textsuperscript{188} A plan is fair and equitable if distribution to each class under the plan in theory equals what they would receive in liquidation.\textsuperscript{189} A court decision on the exercise of this power disciplines both forms of inter-class strategic behaviors, namely imposition of non-value maximizing reorganization or blocking efficient restructuring proposal. Where a group of creditors who have collateral interests attempts to impose an inefficient reorganization on other classes of claimholders, that plan would not be fair and equitable to the latter category of claimants. The court is therefore not likely to exercise its power to cram down the plan on the innocent claimholders. A veto of an innocent class can then frustrate the opportunistic

\begin{footnotes}
\item[184] Quinn, \textit{ supra}, note 109, 5.
\item[185] Quinn, \textit{ supra}, note 109, 24.
\item[188] The United States Bankruptcy Code, §1129(b).
\item[189] The United States Bankruptcy Code, §1129 (a) (10), 1129 (b); Lopucki & Triantis, \textit{supra}, note 23187 at 165; Trebilcock & Katz, \textit{supra}, note 114, 15.
\end{footnotes}
attempt, unless the required majority approval is obtained.\textsuperscript{190} If a class of strategic claimants attempts to block a value-maximizing reorganization even if they stand to benefit from the proposed plan, a bankruptcy court is, of course, likely to cram down the plan on that class of claimants, as the rightholders will not be able to show that the plan is unfair and inequitable to them.

In Hong Kong, where no purpose-built reorganization regime is enacted, the courts do not have express cram-down powers in the same sense as under Chapter 11. Inter-class strategic behaviour, however, has been effectively controlled by the class meeting requirements and court-made rules considered previously. Where one class of creditors attempts to impose a non-value maximizing reorganization on another (say secured creditors), the rule on class meetings, \textit{prima facie}, serves to protect the latter category of claimants. The requirement that any SOA proposal must be approved by all class meetings ordered by the court\textsuperscript{191} means that a proposal will be rejected if it fails to gain the approval of a single class (e.g. the class on which the opportunist class threatens to impose an inefficient proposal).

A class of claimants can also avoid being forced into an inefficient reorganization if they do not need to participate in the proposed reorganization scheme. The exclusion rule, for example, can help achieve this purpose. Under that rule, it will be remembered, there is no need for a class of claimants to be involved where the proposed scheme does not affect their rights or interests. Secured creditors who are able to realize the full value of their claims tend to be indifferent to the choice between liquidation and reorganization. It is therefore not unfair not to include them in a proposed reorganization plan.

Where one class of claimants threatens to block an efficient reorganization (most often employees in Hong Kong), the class meeting requirement will not help, as the veto of a single class of claimants can block the proposal. In Hong Kong, a typical way of resolving the same problem is, in appropriate circumstances, refusing to treat the latter category of claimants as members of a separate class. This is done through the application of both the exclusion rule and the common right rule. The common right rule denies a class of strategic claimants the opportunity to block an efficient proposal by refusing to treat a category of claimants as a separate class just because they share common individual interests in a certain way of disposing the debtor’s assets. Under the common right rule, it will be recalled, only claimants

\textsuperscript{190} The United States Bankruptcy Code, §1126(c).

\textsuperscript{191} \textit{Supra}, note 169.
who share common rights against the company are to be treated as members of the same class.

Where the hold out claimants do share a common right against the company (e.g. where they are all preferential creditors), if their right is not affected under the proposed plan (e.g. if their claim as preferential creditors is to be fully satisfied under the plan), the exclusion rule dictates that they are to be excluded from participating in the proposed scheme. As the court-made classifications rules function to deny strategic claimholders the ability to block a value-maximising reorganization proposal, it can be viewed as some form of cram down device.

**Protecting creditors from intra class opportunism**

The above-mentioned advantage taking strategies can also be employed by a group of strategic creditors against other claimholders within the same class. The majority of a class is able to force a non value-maximizing reorganization on the minority for the reasons considered previously (majority exploitation). A minority group that has enough votes can also threaten to put the debtor company in liquidation, even if reorganization is a more beneficial option for the claimants as a whole, unless a bribe is paid (minority rent-seeking). Once again, voting rules, both statutory and decisional, function to neutralize the effect of advantage taking strategy manoeuvred against members within the same class.

Whilst inter-class majority exploitation can be frustrated by the class meeting requirement, intra-class majority advantage taking can be resolved by a different voting rule under s 166, namely, the supra majority rule. As the supra majority required for the approval of a proposal under s 166 is 75% in value of the total claims in each class, a simple majority holding less than three-fourths of the claims will not be able to force an inefficient reorganization on other members within the same class.

As pointed out previously, a group of small claim holders are able to make their strategic threat more credible as their relatively small stakes in the outcome of a proposed decision gives them more bargaining power than they are entitled to. The main instrument provided under s 166 that neutralizes the voting power augmentation effect of unequal stakes is the so

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192 Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin [2001] 3 HKLRD 634.
193 The function of the classification rules should be read together with the rules on the sanction of an SOA scheme: see supra, note 203 and accompanying text.
194 Quinn, supra, note 109, 6.
195 Section 166(2), CO.
196 Supra, note 181 and accompanying text.
called “weighted voting rule”, which allocates voting rights on the basis of the value held by each claimant. The requirement under s 166 that a proposed plan can only be sanctioned if, among other things, it is approved by a majority in number, representing three-fourths in value of each class or creditors is such a rule. One of the functions of this rule is, obviously, the alignment of a claimant’s voting power with the value of its claim. This rule, obviously, helps prevent small claim holders from obtaining more bargaining power than they are entitled to according to the size of the stakes of their claims.

Quinn points out that while the weighted voting rule is effective in policing the unequal stakes problem within unsecured and preferential creditors, its utility in regulating the same problem within secured creditors is limited. Quinn’s point is that a claimant’s voting power under the weighted voting rule is based on the face value, as distinguished from economic value, of its claim. The face value is only identical to the economic value of a claim when it is possible to realize the full value of the underlying security. Where the underlying assets are worth less than the face value of a claim, the claimant is able to exercise more voting power than it is entitled to (in the light of the economic value of its claim), even under the weighted voting rule.197

Under the Hong Kong System, although the unequal stakes problem within the class of secured creditors cannot be resolved by any of the statutory voting rules, the problem referred to in the preceding paragraph appears to have been successfully policed by the exclusion rule and common right rule, discussed previously. Under the former rule, there is no need for the holders of fully realizable claims to participate in a proposed reorganization plan, as their interests will not be affected by the reorganization.198 Under the latter rule, a secured creditor may participate in the proposed scheme in the same class as unsecured creditors with regard to the portion of its claim that cannot be met by the proceeds resulting in a realization of its security interest.199 The holder of a claim the face value of which is greater than its economic value therefore will have no opportunity to exercise a voting power that is greater than it is entitled to.

197 Quinn, supra, note 109, 25.
199 Re UDL Holdings Ltd [2000] HKEC 429; Re Dickson Group Holdings Ltd [2008] HKEC 899.
(c) Disciplining debtor overreaching

The three principal forms of wealth transfer considered in part III above, namely, assets transfer, assets substitution, and management entrenchment, are only possible where the managers are able to exercise unbridled decision-making powers during the reorganization process. Obviously, wealth transfer will not take place during corporate reorganization if the financially distressed firm is kept out of that process. Keeping firms that do not have a prospect to be successfully reorganized out of the reorganization process is therefore an important way of protecting creditors from debtor opportunism. Where a firm has been let through the gate of restructuring process, creditors’ interests can only be protected through the control over the decision-making powers of the company management. The management power of a debtor’s board can be limited by either removing or constraining the powers of the directors. The Hong Kong System, in its current form, contains effective mechanisms to protect creditors from debtor opportunism through all of the three means of control stated above.

Screening out ineligible firms

The two chief methods of screening out ineligible firms under the Hong Kong SOA-based reorganization system are the mandatory disclosure and the mandatory court appearance requirements. 200 Under this system, the debtor is required to make disclosures on various matters for the purposes of both achieving a moratorium through adjournments of winding up petitions and obtaining court sanction of a proposed plan. To obtain an adjournment, the petitioner will need to prove, among other things, that there are reasonable prospects of the scheme obtaining the approval of both the majority scheme participants and the court. 201 To demonstrate the prospects of obtaining the required approval, the applicant will need to provide the court with information on, among other things, the financial position of the company. A failure to place before the court the company’s financial statements such as the balance sheet or cash flow statement will result in a rejection of the adjournment petition. 202

A proposed s 166 plan will only be sanctioned if (1) “the provisions of the statute have been complied with”, 203 (2) “the class was fairly represented by those who attended the meeting

200 These two methods are also used in America and Canada to monitor the debtor in possession: LoPucki & Triantis, supra, note 187, 150-51.

201 Re UDL Holdings Ltd [1999] 2 HKILRD 817; Credit Lyonnais v SK Global Hong Kong Ltd [2003] 4 HKC 104 at 113 per Rogers V-P; The Cheery City Contractors Ltd [2004] HKEC 504 at para 28 per Kwan J.


and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent”,204 and (3) “the scheme is such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve”.205 To satisfy these conditions, the petitioner is required to attach an explanatory statement to the notice to be sent to the participants in the proposed scheme.206 That statement must explain, among other things, the effect of the proposed scheme and must state any material interests of the directors of the company and the effect of their personal interests in the proposal.207 To demonstrate the effect of the proposed scheme, an explanatory statement typically contains, among other things, information about the company’s assets, as well as a comparison between the creditors’ position in a liquidation and that under the proposed scheme.208

Whereas ineligible firms are screened out through, among other things, the enforcement of disclosure requirements, the enforcement is carried out through mandatory court appearances by the adjournment or scheme sanction petitioner. As mentioned previously, the initial adjournment is, generally speaking, only granted for up to four weeks and the duration of each subsequent adjournment varies between one week and three months. This means that typically an applicant would make a number of appearances before the proposed scheme can be sanctioned. To obtain each of the subsequent adjournment, the application must prove the continuing satisfaction of the ‘in-principle support’ criterion and the ‘viability criterion’ through meeting the relevant disclosure requirements.209 Companies that fail to do so210 are,  

204 Id.
205 Id.
206 Companies Ordinance, s 166A.
207 Companies Ordinance, s 166A (1) (a).
208 Where the proposer of a scheme fails to disclose the required information in the statement, the proposed scheme cannot proceed: Re Cherry City Contractors Ltd [2004] HKEC 504; Re Koltech Development (International) Ltd [2005] HKEC 1190.
209 Supra, note 138 and accompanying text.
210 For example, where the company fails to (1) adduce evidence that it has forwarded a rescue proposal, which has the in-principle support of the scheme participants (ii) provide the court with its financial statements: Re Beauty China Holdings Ltd [2009] HKEC 1499; Re China Motor Vehicle Economic Development Co Ltd [2000] HKEC 61; In the Matter of Gold-Face Holding Ltd [2006] HKEC 1795; Re Greater Beijing First Expressways Ltd [2000] HKEC 651; Re Hong Kong Brewing & Restaurants Ltd [1999] HKEC 637; Re Koltech Development (International) Ltd [2005] HKEC 1190; Re Luen Fai Picegoods & Cloths Co Ltd [2010] HKEC 323; Re Tse Yu Hong Ltd [1999] HKEC 1048. A debtor company also fails to meet the disclosure requirements if the disclosure documents contain misleading information on the rights of scheme participants in a liquidation and a restructuring scenario: Re Cheery City Contractors Ltd [2004] HKEC 504.
in normal circumstances, eliminated from the reorganization process and they have to enter the liquidation process immediately.\footnote{211}{The rigor at which the reorganization cases are screened at the pre-confirmation phase means that when a case reaches the sanctioning stage, most of the ineligible firms would have been sifted out of the reorganization process. That notwithstanding, court appearances at the confirmation stage still plays a valuable gate-keeping role. An example is \textit{Re S Megga Telecommunications Ltd} [2002] HKEC 1344, where the court refused to sanction the proposed scheme on the ground that a certain class of creditors was classified with the general unsecured creditors where they should have been allowed to vote as a separate class. Admittedly, however, \textit{Re S Megga} is on the fair treatment of different classes of creditors, rather than protecting the scheme participants from the overreaching conduct of company controllers.}

\textbf{Displacing Management of Eligible Firms}

Under Hong Kong’s insolvency system, a company’s insolvency often triggers the appointment of an external administrator such as a liquidator, a provisional liquidator, or a receiver and manager.\footnote{212}{Section 196, CO; Tyler, supra, note 82, 994; Paul Kwan, \textit{HONG KONG CORPORATE LAW} 818, 1233 (2006).} The appointment of a liquidator or provisional liquidator results in the displacement of the directors.\footnote{213}{\textit{Re Oriental Inland Steam Co} (1874) 9 Ch App 557 at 560; \textit{Re Union Accident Insurance Co Ltd} [1972] 1 WLR 640; \textit{Austral Brick Co Pty Ltd v Falgat Constructions Pty Ltd} (1990) 2 ACSR 766 at 767; \textit{Amfrank Nominees Pty Ltd v Connell} (1990) 8 ACLC 319; Andrew R Keay, \textit{MCHERSON’S LAW OF COMPANY LIQUIDATION} 303 (2001).} Where a receiver has been appointed with wide management powers, the directors, although officially remaining in their positions, effectively relinquish their powers to the receiver.\footnote{214}{Michael Murray, \textit{KEAY’S INSOLVENCY: PERSONAL AND CORPORATE LAW AND PRACTICE} 460 (6th ed 2008).} While the company is under the management of an external administrator, an SOA is normally proposed by such a person on behalf of the company.\footnote{215}{For example, \textit{Re Yetyue Ltd} [2001] HKEC 1156 and \textit{Re Team Concepts Manufacturing Ltd} [2001] 3 HKLRD K7.} The possibility of company managers, who are not in office, to act opportunistically against the interests of creditors curtailed.

\textbf{Constraining the power of incumbent directors}

A reorganization process under the Hong Kong System may be under the control of the debtor company for two reasons. First, directors may be able to obtain a moratorium through adjournments of winding-up petitions, as mentioned above. They may remain in control until the court has made its decision on the company’s adjournment petition or on the sanctioning of the proposed scheme. Secondly, the company itself may initiate a reorganization process before a winding-up petition is made.\footnote{216}{For examples, see \textit{Re Yetyue Ltd} [2001] HKEC 1156 and \textit{Re Team Concepts Manufacturing Ltd} [2001] 3 HKLRD K7.} In either situation, the task of limiting company controllers’ management power can be achieved through the operation of existing statutory and common law rules designed to constrain company directors’ decision-making powers.
In general law, the court of equity imposed on company directors a fiduciary obligation to act in the best interest of the company. The ‘interest of the company’ means, when the company is insolvent or is approaching insolvency, the aggregate interests of the creditors. Acting in the interest of the company, in this context, therefore means avoiding acting contrary to the interest of company creditors. This understanding on directors’ creditor-regarding obligation is shared by courts of all jurisdictions of British extraction, including Hong Kong.

Whereas reorganization can be carried out under the directors’ management in the absence of any winding-up petition, a creditor may make a petition at any time, as the company is insolvent. The prospect of a director being sued by the liquidator for breach of fiduciary duties, especially where the breach is committed while the company is in a rescue situation, is real. This possibility should constitute a strong deterrence against directors’ overreaching activities.

Statutory rules that have been enacted to control debtor opportunism include (i) provisions designed to deprive the management of the power of asset disposition during the winding up process and (ii) those enacted to protect creditors against dissipation of corporate assets by company controllers while the company is outside the winding-up process.

Section 182, CO is a provision enacted to freeze the directors’ power of asset disposition in the course of liquidation. That provision renders void any disposition of company property after the commencement of winding up, unless with a court order (a ‘validation order’). For the purpose of this provision, presentation of the winding up petition marks the commencement of the winding up process. A court will not make a validation order while

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219 Section 182, CO.

220 The court has jurisdiction to make a validation order after the presentation of the winding up petition notwithstanding that a winding order has not been made: Re Al Levy (Holdings) Ltd [1964] Ch 19.
the company is insolvent unless it is satisfied that the transactions are likely to be profitable and therefore would increase the company’s assets, so as to benefit the creditors. 221

Wealth transfer is virtually impossible where the court has taken control of the power of dealing with corporate assets. Section 182 should therefore be an effective instrument for protecting creditors from debtor opportunism where the company has entered into the winding up process. From the creditors’ point of view, the protective effect of s 182 is highly significant, as most restructurings in Hong Kong are effected after the winding up petition is made.

Where a restructuring scheme is being organized while the company is outside the winding up process, it is hard to control debtor opportunism through removing directors’ decision-making powers. It is, however, possible to constrain the board’s power through some statutorily provided power controlling devices. The most notable devices of this nature that are available under the Hong Kong System include the fraudulent trading provision under the CO and the voidable disposition provision under the Conveyancing and Property Ordinance (CPO).

The fraudulent trading provision, s 275 CO, authorizes the court, on the application of the liquidator, to declare that any persons who were knowing parties to the carrying on of the company’s business with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purposes, are liable to make such contributions to the company assets as the court thinks proper. This provision, however, is of doubtful efficacy. The requirement of dishonest intent, as well as the courts’ insistence on the strict standards of pleading and proof, have virtually rendered the fraudulent provision ‘obsolescent’. 222

While s 275 is of little assistance, the voidable disposition provision under the CPO has proven to be much more effective in combating debtor opportunism. Section 60 of CPO provides that every disposition of property made with intent to defraud creditors shall be


222 V Finch, Directors’ duties: insolvency and the unsecured creditor in CURRENT ISSUES IN INSOLVENCY LAW 96 (A Clarke ed., 1991). A relatively recent Court of Appeal decision that illustrates the requirement of honesty for the purpose of a s 213 (Insolvency Act 1986, the revised English version of CO s 275) suit is Aktieselskabet Dansk Skibsfinansiering v Brothers [2001] 2 BCLC 324, where Lord Hoffmann affirmed that the test of honesty for the purpose of s 213, IA was subjective. There have so far been only two decisions on s 275 in Hong Kong: Re Parvinos Lines Ltd (1985) CWU No 37 of 1977; Wheelock Marden & Co Ltd v Aktieselskabet Dansk Skibsfinansiering [1990] 2 HKC 148. In both cases the plaintiff’s application for a declaration of contravention failed on the ground that requirement of the dishonest intent was not met.
voidable, at the instance of the person thereby prejudiced. In a recent Court of Final Appeal decision in *Tradepower (Holdings) Ltd v Tradepower (Hong Kong) Ltd*, the Court upheld the decision of the court below to set aside a transaction on the ground of s 60. On the need for proving fraudulent intent, Ribeiro PJ ruled that if a disposition of property unsupported by consideration was made by the disponor when or so as to become insolvent, resulting in current or future creditors being subjected to a significant risk of unable to recover their claims in full, “such facts ought in virtually every case to be sufficient to justify the inference of an intent to defraud creditors on the disponor’s part (emphasis added)”. The ratio of Ribeiro PJ on the abovementioned issue appears to be that establishing a contravention of s 60 CPO involves a different inquiry from that required for proving a cause of action based on s 275, CO. Section 275 CO requires courts to grapple with the question of the point at which the carrying on of business by the defendant ceases to involve merely misguided optimism and becomes cheating one’s creditors. Provisions like s 60 CPO, in contrast, “focus on the quality and impact upon creditors of specific dispositions of property in the light of the disponor’s financial condition at the time each disposition was made”. As s 60, CPO involves a far more limited and well-defined inquiry, there was no need for proving dishonest intent, the proof of which is necessary for establishing a s 275 case.

That there is no need to prove the defendant’s actual intent to defraud creditors means that s 60 CPO can be invoked with relative ease to claw back corporate assets disposed of at the expense of creditors. As the utility of s 60 had not really been tested before *Tradepower*, the Court of Appeal’s decision is likely to usher in an era when company creditors are better protected against debtor opportunism.

VI. The efficiency of the Hong Kong System

A. The substantive efficiency of the Hong Kong System

As mentioned previously, the main purpose of corporate reorganization is to achieve correct decision on the deployment of the debtor’s assets and to maximize the pool of assets available for creditors. The substantive efficiency of a reorganization system therefore should

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223 Conveyancing and Property Ordinance, s 60.
224 [2010] 1 HKLRD 674 CFA.
225 [2010] 1 HKLRD 674 at 711 per Ribeiro PJ.
226 [2010] 1 HKLRD 674 at 709-710 per Ribeiro PJ.
227 [2010] 1 HKLRD 674 at 710 per Ribeiro PJ.
228 Supra, notes 103, 104 and accompanying text.
be assessed according to the extent to which the rules constituting the system help reduce the “transaction cost” for achieving these purposes. As this transaction cost is mainly caused by the externalities generated by inter-creditor advantage-taking and debtor opportunism, the yardstick to assess the substantive efficiency of a reorganization system should be the system’s ability to control different forms of strategic behaviour.

As discussed in Part V, strategic behaviors of creditor and debtor opportunism is policed through the stay and collective decision-making mechanisms and the procedural or doctrinal structures designed to protect creditors. The efficiency of each of these mechanisms should be considered in order to determine the efficiency of the overall system.

(a) Stay

As pointed out in Part V, under the Hong Kong System, the statutory and decisional rules on the grant of adjournments for winding-up petitions and the appointment of (provisional) liquidators have successfully been used for facilitating moratoria for corporate reorganization purposes. In terms of neutralising the effect of creditors or debtor’s strategic behaviours, the stay mechanism under the Hong Kong System is arguably superior to the automatic stay that a typical purpose-built reorganization system provides for. A distinguishing feature of the stay mechanism under the Hong Kong System is that the mechanism can only be activated through court orders (on appointment of (provisional) liquidators or on the grant of adjournments). This undoubtedly reduces the possibility of an incorrect allocational decision resulting from inter-creditor strategic behaviours, as ineligible firms are largely screened out of the reorganization process through the scrutiny that the court exercises when considering adjournment or appointment petitions. In terms of control of debtor opportunism, the court controlled gate-keeping process may also be superior to an automatic stay mechanism. Keeping ineligible firms out of the reorganization process denies the debtor an opportunity to effect wealth transfer.

Admittedly, Rogers V-P’s comments on the appropriateness of appointing provisional liquidators for corporate rescue purposes may have caused some perceived uncertainties on the utility of provisional liquidation as a stay device. However, as has been observed in Part V above, His Lordship’s judgment in that case may not be as consequential as has been understood by commentators and lawmakers. Even if this is not the case, the perceived difficulty relating to the use of provisional liquidation as a stay device can be easily resolved by amending the wording in s 192, so that a (provisional) liquidator can be appointed not
only for the purpose of conducting the proceedings in winding up companies but also for conducting debt restructuring. If it is undesirable to give the court power to appoint (provisional) liquidators for rescue purposes through an amendment of s 192, it is always possible to insert a provision on the court’s power to restrain proceedings in s 166. This is exactly what has been done in the SOA provision under Singapore’s Companies Act. Section 210(10) of that Act gives the court the power to stay proceedings upon the proposal of an SOA scheme, provided that no winding up order has been made.229 The use of SOA as a reorganization device with the support of the s 210(1) stay mechanism in Singapore has been highly successful.230

(b) The collective decision-making mechanism

The analysis in Part V demonstrates that the SOA rules provided under s 166 and the classification rules developed by the courts can effectively police various forms of inter-creditor strategic behavior during the deliberation stage of reorganization. As compared to a decision-making procedure that does not require creditors’ approval of a proposal through class meetings, such as the PS procedure proposed for Hong Kong, SOA is definitely a more effective and versatile instrument to regulate inter-claimholder conflicts. The lack of class meeting requirements in the former, for example, makes it harder to control inter-class strategic behaviour. On the other hand, the SOA procedure is flexible enough to accommodate situations where a single creditors’ meeting would afford creditors adequate protection. As has been pointed out previously231, the courts are able to restrict the number of class meetings to one, where there is no need for convening more than one creditors’ meeting, through the application of classification rules. The high degree of conceptual clarity at which these rules have been developed means that they can be applied at a high degree of ease to determine the constitution of a class.

(c) Debtor opportunism control mechanism

Given the gate-keeping function of the stay mechanism under the Hong Kong System, opportunities for the debtor management to engage in overreaching activities, once the debtor is let into the reorganization process, are severely limited. Given that a reorganization plan is

229 Companies Act (Singapore), s 210 (10).
231 Supra, note 177 and accompanying text.
often carried out during a stay obtained through the operation of ordinary corporate insolvency rules, debtor management are often either displaced or deprived of their decision-making powers. The need, hence the cost, for monitoring the debtor, under the Hong Kong System should therefore be considerably lower than that under a reorganizations system which gives debtor management the power to control the reorganization process and to manage the business of the company during that process.

When the debtor is in a position to control the reorganization process and to manage the company, opportunities for them to overreach can be restricted through various rules on the obtaining of a stay or court sanction of the proposal, in addition to doctrinal structures that function to constrain the powers of fiduciaries. The capacity of these rules and doctrinal structures to internalise the externalities generated by debtor opportunism should not be less potent than that provided under a system where the management of the debtor company is generally left to the debtor’s old management.

B. The procedural efficiency of the Hong Kong System

Although there can be little doubt that the Hong Kong System is substantively efficient, there may be an argument, based on the cost for the use of the system, that it is procedurally inefficient. The most obvious examples are the costs for obtaining a stay and the costs on the implementation of the s 166 procedures. The obtainment of both a stay and court sanction under the Hong Kong System, it will be recalled, involves “direct ex post costs”, such as the costs for using the service of legal and insolvency/corporate recovery professionals. Implementation of the s 166 procedure also entails the organization of class meetings, hence the cost.

The above-stated concern about the procedural costs, however, does not necessarily mean that the Hong Kong System is procedurally more expensive to use as compared to a purpose-built reorganization system. For example, it may be hard to prove that the use of the Hong Kong System will necessarily incur more cost as compared to a purpose-built reorganization system. It is true that the Hong Kong System involves more initial court involvement for obtaining a stay and sanction of the proposal. The “product” that SOA scheme participants

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233 Armour, supra, note 232, 15.
purchase, however, is different from that acquired by claimholders with a lower level of initial cost under a purpose-built procedure.

Consider first the achievement of a stay. It is possible to obtain a stay more cheaply under a purpose-built procedure, which does not involve as much court involvement. What the creditors purchase or obtain, in this context, is just a mechanism that protects the firm from dismemberment caused by the creditors’ race to collect. In contrast, the “product” that creditors purchase under the Hong Kong System also includes, in addition to the above-mentioned mechanism, the accuracy of their allocational decision and a mechanism that protects the creditors from debtor opportunism.

The court controlled moratorium-activation process helps eliminate ineligible firms from the reorganization process, thereby increases the accuracy of claimholders’ allocational decision and the level of protection afforded to creditors against debtor opportunism. The likelihood of debtor opportunism in Hong Kong is indicated in the low success rate of adjournment petitions lodged in the Hong Kong courts. According to a survey that the present author has conducted on the courts’ decisions on adjournment petitions, close to 69% of the petitions have been rejected. If the lodging of an adjournment petition by companies ineligible for reorganization signifies a possibility of debtor opportunism, then there may well be a higher level of likelihood of debtor overreaching where an automatic stay can be triggered at the instance of the debtor management. This is especially so where a purpose built reorganization regime, such as the proposed PS procedure, provides for a long period of initial automatic stay. The PS procedure proposed for Hong Kong, it will be recalled, provides for an initial automatic stay for 45 working days.

The value of investing in court control over the collective bargain process is not hard to appreciate either. The cost for court involvement in that process is a small price paid to reduce the possibility of ex post disputes, which can be very costly to settle. Ex post disputes are more likely to arise where the debtor is let into and through the reorganization process without court scrutiny. A number of Australian decisions on Voluntary Administration (VA) and the associated procedure of Deed of Company Arrangement (DCA) illustrate the point.

234 A total of 16 out of the 55 cases that have been survey are on the sanction of adjournment petitions. Out of these 16 cases, sanctions were granted in five cases (Re X10 Ltd [1989] HKLY 108; Re CIL Holdings Ltd [2002] HKEC 97; Re APP (Hong Kong) Ltd [2004] HKEC 522; Re RNA Holdings Ltd [2004] HKEC 1265; Re Advanced Wireless Group Ltd [2007] HKEC764).
Under a VA and DCA, a stay can be obtained and a compromise can be reached through creditors’ meetings without court orders.\textsuperscript{235} Court experience in Australia shows, however, that invocation of these procedures, due to the lack of court control, “often leads to confusion and doubt, which will need ultimately to be resolved by resort to the courts”.\textsuperscript{236} The confusion and doubts that require court clarification are often on whether procedural or even substantive requirements for obtaining a compromise with creditors have been met.\textsuperscript{237} The frequent need for court settlement of \textit{ex post} disputes arguably renders VA and DCA more expensive procedures to use than the stay and decision-making mechanisms under the Hong Kong System for at least two reasons. First, an absence of court control until the emergence of disputes has the effect of postponing the courts’ scrutiny on the debtor’s eligibility for reorganization, the postponement of which may, ironically, lead to poorer allocational decisions. This may happen, where, for example, the failure to meet a procedural requirement, according to a statutorily stipulated rule, leads to an irreversible allocational decision against the wishes of the creditors as a collectivity.\textsuperscript{238}

Secondly, \textit{ex post} disputes are often resolved through a protracted court process. The complexity of the issues facing the courts and the possibility of appeals against court decisions often result in situations where the ultimate fate of an attempted VA in Australia may not be known “until the better part of five years after the event”.\textsuperscript{239} Lengthy delays in the completion of a VA will result in correspondingly long postponement in the deployment of the debtor’s assets and significant increase in the legal and other professional costs.

A further advantage of the decision-making mechanism under the Hong Kong System in terms of procedural cost is that it is possible to waive the collective bargaining process, where the factual matrix shows a lack of possibility of inter creditor advantage taking and, among

\textsuperscript{235} Corporations Act 2001, Part 5.3A, Division 6, 7 (moratorium); ss 436E, 439A (creditors’ meetings).
\textsuperscript{236} \textit{MYT Engineering Pty Ltd v Mulcon Pty Ltd} (1997) 140 FLR 247 at 251 per Powell JA.
\textsuperscript{237} For example, \textit{McVeigh & McDonald v Linen House Pty Ltd & Rugs Galore Australia Ltd} (2000) 18 ACLC 311 (failure of the Administrator to inform creditors of material information); \textit{MYT Engineering Pty Ltd v Mulcon Pty Ltd} (1997) 140 FLR 247 (failure on the part of the debtor management to execute the Company Deed of Arrangement within the statutorily imposed time limit); \textit{Australasian Memory Pty Ltd v Brien} (1998) 29 ACSR 344 (convening a creditors’ meeting on a date earlier than the earliest date permission under the Corporations Act 2001).
\textsuperscript{238} For example, Corporations Act 2001, s 446A provides that a company is taken to have passed into liquidation where the provision (s 444B(2)) on the time of executing the Company Deed of Arrangement is not complied with. The company in \textit{MYT Engineering Pty Ltd v Mulcon Pty Ltd} (1997) 25 ACSR 78 entered into liquidation against the creditors’ collective decision to reorganize the company precisely for this reason.
\textsuperscript{239} \textit{Australasian Memory Pty Ltd v Brien} (1998) 29 ACSR 344 per Powell JA at 347 (commenting on the possible outcome of the appeal to the High Court by the appellant company in \textit{MYT Engineering Pty Ltd v Mulcon Pty Ltd} (1997) 25 ACSR 78).
other things, a large majority of creditors have informally agreed on the proposed reorganization plan. It is possible, it will be remembered, for a (provisional) liquidator, where the restructuring is being organised by such a person, to reach a compromise directly with the creditor without having to go through the s 166 SOA procedure.\textsuperscript{240} The possibility of exercising this power by a (provisional) liquidator surely adds to the procedural efficiency of the Hong Kong System, as a waiver of the s 166 procedure will significantly reduce the cost for collective decision-making.

It is arguable that, as compared to purpose built procedures, the Hong Kong System is procedurally too complicated and too costly for reorganising small companies. The extent to which this view is supported by evidence on reorganising small companies under the System, however, is debatable. In fact, there is evidence that it is possible to complete the reorganization process for a small company under the Hong Kong System in about four months.\textsuperscript{241} This record does not appear to compare unfavorably with the figures relating to reorganization of small companies under a purpose-built procedure.\textsuperscript{242} The speed at which the reorganization of a small company can be accomplished under the Hong Kong System does not appear to be consistent with the above-mentioned perception on the suitability of the System for reorganizing small companies.

VII: Conclusion

The above assessment of the efficiency of the Hong Kong System by no means precludes the possibility that a purpose-built reorganization procedure, such as the proposed PS procedure, may be more efficient. This possibility, however, does not necessarily constitute conclusive evidence on the utility of such a procedure for Hong Kong. This can be explained from the angle of path dependence. If the outcome of the path locked in due to some initial actions or decision is efficient, a change of path is \textit{ipso facto} unjustifiable. Nor is it possible, assuming that the more efficient the outcome is, the more durable the path is. Even where the outcome turns out to be inefficient, a change of path may not take place. The investment that has been

\textsuperscript{240} Section 199, CO; See \textit{supra}, notes 92 - 97 and accompanying text.

\textsuperscript{241} This is the case in \textit{Re Yetyue Ltd} [2001] HKEC 1156. There, the company was a small trading company in undergarments. The need for a restructuring arose out of the deterioration of the company’s liquidity caused by the financial difficulty of a major customer, which was unable to discharge its debt of HK$1.6 million. The company was able to reach a compromise with its trade creditors through the SOA procedure within four months and two days (the class meeting was ordered on 16 May 2001 and the proposed plan was sanctioned on 18 September 2001).

\textsuperscript{242} In the United States, for example, it takes three to five months for a bankruptcy court just to \textit{identify} whether a small firm is eligible to reorganise under Chapter 11 of the US Bankruptcy Code, not to say the \textit{completion} of the whole process: See Baird, \textit{supra}, note 89, 209.
made on the development of and adaption to the existing path, as well as the cost for building and adapting to an alternative path are likely to reinforce the durability of the existing path.\textsuperscript{243}

The society of Hong Kong as a whole has invested quite heavily in the development of the Hong Kong System since at least the mid 1990s. Enterprises and stakeholders therein have adapted their behavior and made fixed investments in response to laws and other institutions constituting the Hong Kong System. These adaptations make it costly to switch to new institutions.\textsuperscript{244} That is why, even if the proposed PS procedure is successfully enacted sometime in the future, reorganization in Hong Kong is likely to be facilitated through the Hong Kong System wherever that is possible. The inducement of staying in the existing formal reorganization path will be reinforced if the major inadequacy of the SOA regime under the CO, namely, the lack of a stay provision, is rectified, which can be easily done.\textsuperscript{245} A purpose-built reorganization procedure is therefore not imperative for Hong Kong. It will be interesting to see the extent to which the Hong Kong System will be supplanted by the PS procedure, should the latter be successfully enacted.

\textsuperscript{243} Margolis and Liebowitz, supra, note 1, 19.
\textsuperscript{244} Margolis and Liebowitz, supra, note 1, 19.
\textsuperscript{245} On how this can be done, see supra, note 230 and accompanying text.