

Corporate insolvency in the time of the coronavirus pandemic in Hong Kong

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No one expected that the culprit responsible for putting an end to Wall Street's 11-year "bull market" would be the COVID-19 pandemic. Even as the situation stabilises in Asia, the COVID-19 pandemic has battered economies around the globe and there is uncertainty regarding more waves coming as cases rebound. Stock markets have plummeted and retrenchment rates are at an all-time high. Governments across the world have been announcing unprecedented stimulus packages aimed at tiding businesses through the pandemic. In Hong Kong, the government announced on 8 April 2020 that it would be offering HK\$137.5 billion (approximately US\$17.7 billion) to aid ailing businesses and to safeguard employment. With the Hong Kong economy still reeling from the impact of the social unrest over the past few months, it is uncertain whether such measures will be sufficient to keep businesses alive. In such times, it is important to be aware of what directors should or should not do when the company is insolvent or nearing insolvency.

Duties of a director when the company is insolvent

As a general rule, directors owe their duties to the company as a whole. However, when a company is insolvent or is in a dangerous financial position, the director will be under a duty to take into account the interests of the creditors of the company. This is because the creditors of the company are entitled to look to the assets of the company to satisfy their debts in priority to those of the shareholders.

It is also important to note that where there are different groups of creditors of the company, the directors of an insolvent company is obliged to regard the interest of the company's creditors **as a whole**. Thus, a director may be in breach of his duties if he: (i) does something which favours a particular creditor over other creditors of the company without believing that it benefits the interest of the creditors as a class, or (ii) knowingly causes the company to pay away its assets to a particular creditor. While the interest of creditors may be prejudiced because of a breach committed by the directors, individual creditors are not able to commence legal proceedings against the errant directors directly under the common law. Instead, it is usually the liquidator of the company who will commence proceedings against the errant directors for breach of director's duties. The liquidator may also be entitled to claim for equitable remedies against an errant director to restore the company to the position it was in prior to the breach of duty, for the benefit of the creditors as a whole.

Transactions involving the company

When the company is insolvent or on the brink of insolvency, the directors will also have to be cautious in relation to the transactions involving the company. For instance, some directors may be pressurised or tempted to repay the debts of internal creditors of the company (e.g. directors or shareholders) before settling debts owed to external creditors. This may amount to a breach of directors' duties as well. Such payments may also be regarded as an unfair preference, and may be voidable in certain circumstances upon an application by the liquidator, pursuant to the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("**CWUMPO**"). Apart from unfair preference, directors should also take note not to enter into transactions at an undervalue. One example would be selling the company's factory to the spouse of a shareholder of the company at a price that is grossly below market value. Similarly, such transactions may be set aside upon an application by the liquidator pursuant to the CWUMPO.

Unlike in England and Wales and in Singapore, the current Hong Kong insolvency regime does not have a provision for insolvent trading. However, there is a provision for fraudulent trading. Pursuant to section 275 of the CWUMPO, if upon winding up of the company, it is found that the director of the insolvent company had knowingly carried on business of the company with intent to defraud creditors or for a fraudulent purpose, the director may be found to be personally liable, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct. The director may also incur criminal penalty, which consists of a fine and/or a jail sentence. The Court may also

make a disqualification order against any directors (including shadow directors) who were knowingly parties to the fraudulent trading, and the maximum period of disqualification is 15 years.

Apart from the disqualification of directors on the basis of fraud, the Court may also make a disqualification order against any director (including a shadow director) of a company that is being wound up, if the director's conduct makes him/her unfit to participate in the management of a company. The minimum period of disqualification is one year, and the maximum period of disqualification is 15 years.

What is next for insolvent companies?

Hong Kong has recently announced its plan to revive a corporate rescue bill ("**Bill**") which was first mooted in 1996. One of the features of the Bill would be the proposal for provisions relating to insolvent trading to be incorporated into the Hong Kong insolvency regime. Under the proposed directions, directors and shadow directors of the insolvent company will be personally liable if they allow the company to continue to trade and incur debts when they knew, or ought to have known that the company was insolvent, or that there was no reasonable prospect of avoiding insolvency. If insolvent trading becomes part of the insolvency regime in Hong Kong, directors would have to exercise extra care and caution in conducting the affairs of the company, as insolvent trading is much easier to establish than fraudulent trading.

Another important aspect of the Bill is that it will include US Chapter 11-style provisions, which will allow debt-stricken companies to petition for an automatic moratorium with global effect. This means that all civil proceedings against the company (subject to exceptions) will be postponed. Such a moratorium will give the provisional supervisor that is appointed to manage and control the company some breathing space to formulate a voluntary arrangement proposal to creditors, and to restructure the company's finance. Creditors may also vote to extend the period of the moratorium for up to six months.

The proposed introduction of the US Chapter 11-style provisions could not have come at a better time. Corporate restructuring may be the key to survival for some companies who are facing financial difficulties caused by the COVID-19 outbreak, as it would buy these companies time to work on rehabilitation plans. This would be more desirable as compared to having to wind up or liquidate the company, and watching years of hard work go down the drain.


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