Distressed Debt in Hong Kong: An Insolvency Primer for Private Equity

Recent shocks to the financial markets as well as deteriorating economic conditions have brought insolvency issues sharply back into focus. For some hedge funds and private equity funds, insolvency has come unwelcome in the form of the deteriorating financial condition of a portfolio company to whom loans have been made or whose debt the funds have acquired. In this article, we review basic Hong Kong insolvency law concepts and outline debt recovery options.

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A private equity fund or hedge fund facing the possible or actual insolvency of a debtor portfolio company will generally wish to assess its legal rights under its financing agreements with the debtor company. In this regard, the fund will normally wish to determine (i) whether it is obliged to make any further advances to the debtor company, (ii) the validity, priority and sufficiency of any security for its debt, and (iii) the viability and cost-effectiveness of pursuing any restructuring of the debt.

If the fund reaches the view that it is in a better position than the other creditors because it is in a position to recover its debt in full when other creditors may not be, subject to the desire to maintain a longer term relationship with the debtor company, it may be advantageous for the fund to simply accelerate its debt and get out.

However, if the fund reaches the view that it will be unable to recover its debt in full, it will need to weigh whether its recovery is likely to be higher by selling the debt, pursuing a restructuring or simply placing the debtor company into liquidation.

In Hong Kong, where a creditor wishes to place a debtor company into liquidation, it will begin a procedure known as compulsory winding-up by petitioning the court for a winding-up order on the basis typically that the debtor company is unable to pay its debts. When a winding-up order is granted, the order triggers a statutory regime for the protection and distribution of the assets of the debtor company. This regime prevents a first-come first-serve scramble by creditors which would not only prejudice creditors making late claims but which would also force all creditors to incur substantial

costs in the competitive process of enforcement of their claims against other creditors.

Enforcement of Security

A fund may have a security interest over the property of the debtor company. In this case, the security package will typically determine the rights of the fund including the power of the fund to sell the property subject to the security and the priority of the fund as regards the proceeds of such sale.

If the sale of this property would be insufficient to discharge the debt, the fund would be an unsecured creditor in the winding-up of the debtor company for the balance of the debt outstanding after the proceeds of the sale had been applied to the debt. If the security interest is subordinate to a prior security interest, then the fund will need to assess how much of the proceeds of the sale of the property will be available after satisfying the claims of creditors ranking ahead.

In the case of a floating charge, by statute, the claim of the holder of the charge in respect of the proceeds from a disposition of the property may be subordinated to those of preferential creditors, such as employees.

Power of Sale

The security package will typically give the fund, as creditor, an express power of sale, a power which may be exercised without court proceedings. However, in exercising such a power of sale, the fund may wish to take possession (if it does not already have possession) as a precursor to sale so that it can give possession of the property to the purchaser. Whilst a fund may be entitled to possession, where the property subject to the security interest is in the hands of the debtor company, court proceedings may be unavoidable in practice where the debtor company does not freely deliver possession.

Receivership

The security package may give the fund a right to appoint a receiver over the property which is the subject of the security interest. In this case, the appointment may be made without a court order and the powers of the receiver will be defined in the security documentation. Typically, in the case of a security interest over the entire business and undertaking of the debtor company, these rights will include the right to manage the business of the debtor company, to collect income from the business to pay the debt and to sell the business, or parts of it, to discharge the debt.

Restructuring

Restructuring involves the exchange, replacement or modification of financial obligations that have previously been issued and that are now financially burdensome or in default. In the short-term, a restructuring may seek to eliminate losses at the debtor company through the sale or closure of operations, the cutting of costs, improving cash control, deferring or postponing payments due to creditors, negotiation of a reduction in the amount due to creditors or in the rate of interest, or swapping debt for equity. Over the longer-term, a restructuring may seek to restore growth and margins in the debtor company. A fund may wish to support a restructuring to

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avoid winding-up and to enable the debtor company to continue as a going concern that can repay its debts in full.

Absence of Statutory Regime for Restructuring

Unlike many other developed jurisdictions, Hong Kong law does not explicitly recognize a public policy interest in the restructuring of insolvent companies so that creditors may benefit from the continuing operation of such companies. There are no statutory provisions to allow for priority of creditors who lend during the restructuring process, both in terms of ranking of claims and security. Consequently, a fund that may be interested in providing fresh financing (so called debtor-in-possession financing) to enable the debtor company to meet cash requirements and continue as an ongoing concern is well advised to seek competent legal advice.

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Contractual Restructuring

Contractual restructuring allows for private work-out arrangements to be made between the debtor company and its creditors. Their success is contingent upon unanimous approval of the plan by creditors. They are therefore best suited to situations where the debtor company retains real value as a going concern (*i.e.* is merely undergoing a temporary liquidity problem) and either has a small number of creditors or whose creditors are primarily Hong Kong banks.

Hong Kong banks are subject to the Guidelines on Corporate Difficulties ("**HKAB Guidelines**") issued by the Hong Kong Monetary Authority and the Hong Kong Association of Banks. The HKAB Guidelines are broadly consistent with the INSOL (International Federation of Insolvency Professionals) Statement of Principles for a Global Approach to Multi-Creditor Workouts and provide for banks to be supportive where a debtor company has approached them in respect of financial difficulties.

Under the HKAB Guidelines, banks should withhold enforcement action on their debts and ensure that the debtor company has sufficient liquidity to continue trading until a considered view of its prospects can be reached. For this purpose, the banks may appoint a lead bank as well as, in the case of a large lending group, a steering committee to negotiate with the debtor company.

Standstill Agreement

If the view is taken that a restructuring may be viable, creditors may enter into a standstill agreement so as to give the debtor company an opportunity to produce, negotiate and implement a restructuring plan. Typically, such an agreement will provide for creditors to freeze their exposures as of a fixed date, to maintain their existing facilities up to the amount of their exposures on that date, to withhold action to enforce debts and to maintain their individual positions relative to other creditors (*e.g.* by not taking fresh security or guarantees that are not available

to all creditors. Conversely, the agreement will restrict the debtor company's business so as not to adversely affect the prospective recovery of creditors and give creditors the ability to monitor the cashflow of the debtor company.

If the debtor company and its creditors reach an agreement as to the terms of a restructuring, the parties sign a restructuring agreement which is typically implemented by the lead bank or steering committee.

Provisional Liquidation

If the fund believes that it may be possible to restructure the debtor company but is unable to reach a consensus with a number of dissenting creditors to effect a standstill, it may wish to petition for a winding-up of the company and apply to court for the appointment of a provisional liquidator with the power to explore a restructuring and carry on the business of the company in the interim. The fund in this case will however, need to establish a genuine need for a provisional liquidator to protect the assets of the debtor company from dissipation to the prejudice of the body of creditors as a whole and will not succeed in the appointment of a provisional liquidator for the sole purpose of exploring a restructuring.

If the court appoints a provisional liquidator, the appointment will automatically stay actions or proceedings against the company (except with the consent of the court), thereby effecting a standstill of in court creditor process that might prematurely terminate restructuring efforts.

Schemes of Arrangement

Even with a standstill in place, a restructuring may fail for lack of consensus amongst creditors as to terms. As noted above, a contractual workout requires the consent of every creditor. In this respect, smaller creditors may hold out for better terms or the prospect that a larger creditor will buy out their debt, yielding a higher recovery than would otherwise be possible on a winding-up.

A statutory scheme of arrangement may be used to bind all creditors and shareholders to a restructuring even without unanimity. Because a scheme over-rides the wishes of dissenting creditors and shareholders, to become effective, a scheme must first be approved by a majority in number (*i.e.* 50 per cent.) representing 75 per cent. or more by value of the members of each class of creditor and shareholder of the debtor and, if so approved, must then be sanctioned by the court.

Drawbacks of Schemes

However, a scheme can take months to complete. In the interim period between when the scheme is proposed and the scheme is sanctioned by the court, the assets of the debtor company are at risk of dissipation while the liabilities of the debtor company may be increasing, without any assurance that the scheme will be approved. At the same time, there is an ongoing risk that individual creditors will seek to enforce their debt. Secured creditors dissatisfied with the proposed terms may wield their rights to appoint receivers, to take possession of secured property or exercise rights

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of sale. Unsecured creditors may, in the absence of a provisional liquidation, petition to wind-up the company.

Adding to the risk, the court may refuse to sanction the scheme if it considers that the classes of creditors and shareholders have been improperly defined for the purposes of obtaining approval.

Winding-Up

Hong Kong insolvency law establishes a regime for the protection of the assets of the debtor company for the general benefit of creditors and shareholders as a whole

Where other options for recovery have been exhausted, a financial creditor may petition to wind-up a debtor company. The petition is often based on the grounds that a creditor has served a statutory demand for payment on the debtor company and the company has not within 21 days satisfied the demand. The petition will typically be heard within 2 months and the debtor company may oppose it, as where it *bona fide* disputes the debt. On the grant of a winding-up order, like many other developed jurisdictions, Hong Kong insolvency law broadly operates on 3 principles.

Protection of Assets

First, Hong Kong insolvency law establishes a regime for the protection of the assets of the debtor company for the general benefit of creditors and shareholders as a whole. All court proceedings against the debtor company are stayed (except with the consent of the court) and any dispositions of the property of the debtor company are void as from the date of the petition (unless otherwise validated by the court).

The court appoints a liquidator to take custody and control of the property of the debtor company. The liquidator may disclaim onerous property of the debtor company and will enquire into the conduct of the affairs of the debtor company with a view to determining the presence of any impropriety.

Where appropriate, directors of the debtor company may be prosecuted as may occur where they carried on the business of the debtor company with intent to defraud creditors or where they frustrate the ability of the liquidator to enquire into the affairs of the debtor company (*e.g.* by destroying books and records of the debtor company).

Equally, where appropriate, the court may void or declare invalid transactions before the winding-up which have improperly dissipated assets of the debtor company. So, for example, the court may declare invalid any transfer of the debtor company's property within the 6 months prior to the winding-up which has unfairly put one creditor in a better position than other creditors.

This regime for asset protection does not however, generally affect the ability of secured creditors (*i.e.* creditors who have taken a security interest, such as a charge, over the assets of the debtor) to enforce their security.

Collective Enforcement of Rights

Secondly, Hong Kong insolvency law establishes a collective procedure for the enforcement of rights which arose prior to the commencement of the winding-up. Under this procedure, all creditors must set-off any mutual credits and debits between themselves and the debtor company and, in respect of the remaining claim, submit a proof of debt within pre-

scribed times. The liquidator may admit or reject the claim. In discharging his responsibilities, the liquidator acts in a quasi-judicial capacity and is subject to a duty to maintain an even and impartial hand between all persons interested in the winding-up.

Distribution of Assets

Thirdly, Hong Kong insolvency law establishes a system of ranking the claims of creditors, giving the highest priority to the costs of the liquidation followed by the claims of preferential creditors (*i.e.* creditors who for public policy reasons are given preference over other creditors), such as employees, and then claims by holders of floating charges. The claims of the remaining creditors are generally treated *pari passu*, meaning that the remaining creditors share proportionally (*i.e.* each creditor receives the same amount on every dollar owed to it). Once all the assets of the company have been realized, investigation completed and a final dividend paid, the liquidator may apply to court to be released and eventually, the company may be dissolved. ■

TIMOTHY LOH, SOLICITORS serves as Hong Kong and international legal counsel to financial institutions including hedge funds, private equity funds and traditional funds. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200. It is ranked by the International Financial Law Review 1000 as a leading practice in Hong Kong banking law.