May 6, 2019

Provisional Liquidation for Restructuring: A Review of the State of the Law
Provisional Liquidation for Restructuring: A Review of the State of the Law

Whilst the Companies Ordinance in Hong Kong provides that a scheme of arrangement may be carried out for the purpose of a debt restructuring, it makes no provision for a moratorium on creditor enforcement processes during the time in which the scheme is in progress. For a time, the courts filled this legislative lacuna by placing companies into provisional liquidation and empowering the provisional liquidators to pursue a corporate rescue with the benefit of the statutory moratorium on creditor enforcement processes that is triggered upon a provisional liquidation. However, a 2006 decision of the Court of Appeal casts doubt on the viability of this approach. These doubts have lingered since then though the courts have continued from time to time to tolerate provisional liquidations for restructuring purposes. The recent decision in Re China Solar goes some way to allaying these doubts.

By Timothy Loh

Unlike many jurisdictions, Hong Kong does not have a statutory regime designed to facilitate a restructuring of a company’s debt, thus enabling the company to effect a rescue, avoid liquidation and continue as a going concern. Whilst the Companies Ordinance (“CO”) does provide for schemes of arrangement to bind creditors to a restructuring proposal, there is no statutory moratorium to restrict creditors from frustrating the scheme by placing the company into liquidation before the scheme can be approved.

The courts have stepped in to fill the legislative lacuna and recent developments in the caselaw suggest that there is greater room than many practitioners have previously thought possible to leverage the winding-up provisions of Companies (Winding-up and Miscellaneous Provisions) Ordinance (“CWUMPO”) to facilitate a corporate rescue.

Background

CWUMPO provides that where a winding-up order is made against a company or where a provisional liquidator is appointed in respect of a company, no action or proceeding may be proceeded with or commenced against the company except with the leave of the court. For just over 15 years, the courts have grappled with the circumstances in which this statutory moratorium can be used to effect a corporate rescue.

The starting point for this discussion is Re Kewew Technology, where the
“Accordingly, whilst the appointment of a provisional liquidator has traditionally been made to preserve and protect assets as a matter of urgency, the court held that there was no jurisprudential objection to empowering provisional liquidators to explore a corporate rescue.”

court observed that CWUMPO neither circumscribes the circumstances in which a court may appoint a provisional liquidator nor restricts the powers which the court may grant to a provisional liquidator. Accordingly, whilst the appointment of a provisional liquidator has traditionally been made to preserve and protect assets as a matter of urgency, the court held that there was no jurisprudential objection to empowering provisional liquidators to explore a corporate rescue.

Re Keview Technology appeared to open the door to using provisional liquidation as a means to effect a corporate rescue, taking advantage of the statutory moratorium available under CWUMPO on appointment of a provisional liquidator and the fact that provisional liquidation inherently takes place before a winding-up order has been made. Indeed, at first, it was thought that so long as it was intended that it was likely that a winding-up order would be made if a rescue did not come to fruition, it was permissible to appoint a provisional liquidator for the express purpose of such a rescue.

However, in Re Legend International, the Court of Appeal clarified that it was impermissible to appoint a provisional liquidator for the express purpose of pursuing a rescue and that a provisional liquidator could only be appointed for the purpose of a winding-up. The court stated:

“...it is clear on the wording of those sections that the appointment of a provisional liquidator must be for the purposes of a winding-up. Provided that those purposes exist there is no objection to extra powers being given to the provisional liquidator(s), for example those that would enable the presentation of an application [for a scheme of arrangement]...

The power of the court under section 192 is to appoint a liquidator or liquidators for the purposes of the winding-up not for the purposes of avoiding the winding-up.”

Rescue and Winding-Up

Following the decision in Re Legend International, many practitioners thought that, strictly speaking, it was not possible to appoint a provisional liquidator to effect a corporate rescue on the basis that a corporate rescue was incompatible with the purpose of a winding-up, namely to see to the liquidation of the company. However, as one court noted “the reality is that on occasions the jurisdiction, despite the decision in Re Legend International Resorts Ltd., has continued to be used as a mechanism through which the debt particularly of listed companies is restructured”.

“The law has never been that provisional liquidation is meant to lead to a winding-up. The law has always been that a provisional liquidation is meant to ensure that the operation of a winding-up would not be frustrated, if there is a winding-up...” [emphasis added]

Restructuring to Protect Assets

The court in Re China Solar stated “a restructuring is in many circumstances consistent with the provisional liquidator’s duty to preserve assets”, emphasizing in this regard that “a reduction of the company’s liabilities is the correlative of the protection of its assets”. In so saying, the court commented that Re Legend International "was merely affirming the conventional commencement criteria for provisional liquidation", suggesting that a debt restructuring was consistent with a provisional liquidator’s objective of asset protection, as long as the appointment of a provisional liquidator was properly justified on the grounds of preserving assets in jeopardy.

In many cases, the justification may lie in form over substance. Citing Re Legend International the court in Re China Solar affirmed:
“...it appears that a corporate rescue is nevertheless permissible so long as the grounds for provisional liquidation are framed on the basis of a debt restructuring to protect assets in jeopardy rather than on the basis of a debt restructuring to avoid a winding-up altogether.”

“There is, nevertheless, a significant difference between the appointment of provisional liquidators on the basis that the Company is insolvent and that the assets are in jeopardy and the appointment of provisional liquidators solely for the purpose of enabling a corporate rescue to take place. The difference, may, in most cases, be merely a matter of emphasis, but in the final analysis the difference exists.” [emphasis added]

In this regard, the court in Re China Solar explained that the view taken by the court in Re Legend International was merely an emphasis that:

“Where the matters associated with a winding-up are absent, in particular where the company’s assets are not in jeopardy, it would not be appropriate to order a provisional liquidation, despite the company’s general need for a restructuring.”

As to whether there are assets in jeopardy which could justify the appointment of a provisional liquidator, the court in Re China Solar stressed that “[i]t has never been the law that a potential loss of assets solely consequent upon a winding-up means the assets are in jeopardy and this jeopardy can support the appointment of provisional liquidators.” Accordingly, it remains significant to identify the assets at risk in each case for provisional liquidation purposes.

Taking both decisions together, it appears that a corporate rescue is nevertheless permissible so long as the grounds for provisional liquidation are framed on the basis of a debt restructuring to protect assets in jeopardy rather than on the basis of a debt restructuring to avoid a winding-up altogether.

Listing Status as An Asset

The court in Re China Solar determined that whilst the listing status of a listed company is not a type of asset that can be distributed on a winding-up, it is nevertheless an asset and a provisional liquidator can be appointed to protect this asset. This is not to say that a mere risk of de-listing by the Stock Exchange of Hong Kong (“SEHK”) can found the basis for appointing a provisional liquidator. The court noted that a provisional liquidator may be appointed to investigate the affairs of the company and where the circumstances of the company being subjected to the risk of de-listing are worthy of investigation, the need for such an investigation can found the basis for provisional liquidation. In this case, there were accounting and management irregularities which had not been explained satisfactorily to the SEHK.

Summary of the Law

As a result of Re China Solar, it appears that whilst a provisional liquidation is not always available to effect a corporate rescue, there will be many circumstances in which it will be a viable alternative.

- A threshold issue to the appointment of a provisional liquidator to effect a corporate rescue is that it is likely that a winding-up order would be made. Normally, this will mean that the company is unable to pay its debts.

- If this threshold issue is met, there must be a proper purpose for the provisional liquidation, namely to safeguard against the risk of dissipation of the company’s assets or the need for an independent investigation of the affairs of the company including in respect of officer malfeasance. In the former regard, it is improper to pursue the provisional liquidation to pursue a restructuring whose objective is to obviate a winding-up. However, it may be proper to pursue the provisional liquidation to effect a restructuring where there are assets at risk that require preservation by a provisional liquidator.