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Chu, Tina and Young, Angus (2010) *Legislative proposals to codify directors' liability for insolvent trading in Hong Kong : a 10-year journey.* Insolvency Law Journal, 18(3). pp. 158-168.

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Legislative Proposals to Codify Directors' Liability for Insolvent Trading in Hong Kong: A Ten-Year Journey

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ABSTRACT:

Hong Kong is a modern global city with a reputation for well-regulated financial markets, but for years, the government had been trying to enact laws on corporate rescue procedures with relatively little success. It is under the pretext of the Global Financial Crisis, the threat of a future economic meltdown gave the Hong Kong government the impetus to revisit this issue. This third attempt to codify statutory obligations on directors' liability for insolvent trading has been criticised for either setting the standards too high or low for directors trading whilst insolvent. There is also some reservation given the beliefs and values of directors in Chinese family-owned and controlled companies. These companies would most likely trade out the difficult times. Nevertheless, this does not negate from the fact that the enactment of corporate rescue procedures in Hong Kong in 2010 is a momentous achievement for the Hong Kong government.

INTRODUCTION

This article retraces the rationale and debate on the long awaited reforms to corporate rescue procedures in Hong Kong. The recent attempt to reintroduce a Bill to the Hong Kong Legislative

Council was based on the Companies Ordinance (CO) (Amendments) Bill 2000 and the Companies (Corporate Rescue) Bill 2001 (CCR Bill).[1] One of the controversial proposals was to impose personal liability on directors for insolvent trading.[2] The two previous failed attempts to enact corporate rescue procedure made the Hong Kong government cautious and weary. As a strategic response, current proposals amended the original provisions of the CCR Bill 2001. In particular, section 295C of the CCR Bill was "watered down" to appease the business community.

In October 2009, the Financial Services and Treasury Bureau (FSTB) released a Consultation Paper to seek public submission on the amended provisions of the new proposed legislation under the pretext of the Hong Kong government policy initiatives in the aftermath of the Global Economic Crisis of 2008-9. In July 2010, the FSTB published a conclusion paper from public consultations. From the public submissions, there was considerable support for this legislation when the Hong Kong government removed controversial wordings from the previous proposal in this recent attempt.

This article will discuss the rationale behind the Hong Kong government's initiatives to enact laws to regulate corporate rescue procedures, retrace some of the debates and provisions of the original Bills which failed to be enacted, and examine the most recent set of proposals, in particular on the issue of directors' liability for insolvent trading. Even though this paper is

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[1] See *Companies (Corporate Rescue) Bill 2001 (Hong Kong)* draft section 295C. http://www.legco.gov.hk/yr00-01/english/bills/c025-e.pdf viewed 18 June 2010.
[2] See *Companies (Corporate Rescue) Bill 2001* (Hong Kong) draft section 295E. http://www.legco.gov.hk/yr00-01/english/bills/c025-e.pdf viewed 18 June 2010.

primarily descriptive, the contribution is to review and comment on the various reincarnations of the Bills into its current set of proposals, as well offer some insights into corporate law reform in Hong Kong. Furthermore, this paper shall delve into the cultural dimensions of Chinese family-owned and controlled companies and its impact on the directors' way of thinking on insolvency.

THE IMPETUS FOR CORPORATE RESCUE LAWS

Hong Kong is a modern cosmopolitan city known to the international business community as one of the freest economy of the world. It was also known as one of the "tiger" economies in Asia. The territory had experienced rapid economic growth since the 1970s.[3] From the humble beginning of a small fishing village known to the British as a "barren rock" in the 18th century to become a global business city in the 21st century. The engine behind the emergence of this "miracle" economy is the innovative adaptability and entrepreneurial spirit of local businessmen and women.[4] Majority of the businesses are family-owned and controlled companies governed under the centralised control of the founder who is usually the head of the family.[5] The key to their success stems from the ability of these companies to be highly adaptive to a rapidly changing business environment,[6] and their aggressive tenacity in capitalising business opportunities.[7] Hence taking on highly risky ventures is norm when it comes to "doing business" in Hong Kong.

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[3] Chowhury A and Islam I, *The Newly Industrialising Economies of East Asia* (Routledge, London, 1993) pp12-17.
[4] Yu T, 'From a 'Barren Rock' to the Financial Hub of East Asia: Hong Kong's Economic Transformation in the Coordinating Perspective' (2004) 10(3) *Asia Pacific Business Review* 360.
[5] See Young A, Li G, and Lau A, 'Corporate Governance in China: The Role of the State and Ideology in Shaping Reforms' (2007) 28(7) *The Company Lawyer* 204.
[6] Redding G, *The Spirit of Chinese Capitalism* (DeGruyter, New York, 1990) pp 221-225.
[7] Redding, n6, p277.

With the advent of the Asian financial crisis in 1997, it revealed the structural weaknesses and excesses of the Hong Kong economy. Much of which was about the drawbacks of its highly geared business ventures and over inflated asset pricing driven by short-term speculative gains.[8] For example, the corporate collapse of one of Hong Kong's most reputable investment houses in 1998 Peregrine Investment Holdings Ltd literally made the financial sector in Hong Kong jitter.[9] When the Indonesian rupiah took a dive as a result of the Asian Financial Crisis so did Peregrine's investments in Indonesia.[10] During Peregrine's liquidation, five of its directors were disqualified for failing to exercise the duty of care, skill and diligence. Clearly highly risky investments for short-term gains were fatal.[11] In hindsight, if the company had a fighting chance of being rescued, the best candidates would have been those charged with governing and managing the investment bank.[12] This was a lesson not to be lightly.

More recently, the GFC in 2008-9 reiterated the fact that Hong Kong being a small open economy is susceptible to external economic shocks. The corporate collapse of the Lehman Brothers in the US had major ripple effects on Hong Kong's economic stability, from the daily street protests by aggrieved investors who lost their life savings to the significant dive in Hong

[8] See Alba P, Bhattacharya A, Claessens S, Ghosh S and Hernandez L, 'The Role of Macroeconomic and Financial Sector Linkages in East Asia's Crisis' in Agenor PR, Miller M, Vines D and Weber A (ed.) *The Asian Financial Crisis: Causes, Contagion and Consequences* (Cambridge University Press, UK, 1999) pp 55-56.
[9] Richburg K, 'Hong Kong Investment Firm Folds' *Wasington Post* (Washington), 13 January 1998, A12.
[10] Tang A, *Insolvency in China and Hong Kong: A Practitioner's Perspective* (Sweet & Maxwell Asia, Hong Kong, 2005) 401.
[11] Tang, n10, p416. See, *Philip Leigh Tose v The Official Receiver* [2002] 3 HKLRD 235, HCAL63/2002; *Wong Wing Cheon, Peter v The Official Receiver* HCAL64/2002.
[12] Tang, n10, p 419.

Kong's share prices, about a 5.4 percent plunge when the news of the collapse was made public.[13]

Economic crises are catalyst for changes. It is under this pretext the Hong Kong government plans to introduce legislation on corporate rescue measures. The *Review of Corporate Rescue Procedure Legislative Proposals Consultation Paper* (Consultation Paper) drafted by the Hong Kong Financial Services and Treasury Bureau (FSTB) states (at page 2): [14]

> As part of the response to the recent global financial crisis, the Government has adopted the recommendation made by the Task Force on Economic Challenges in late January 2009 to re-consider the introduction of a corporate rescue procedure to facilitate companies with viable long-term business prospects, but in short term financial difficulty, to turn around or restructure.

Even though casual factors of corporate failure are complex, there are some commonalities. Over the centuries, major corporate collapses have some of the common tell tale signs; they were creative accounting, mismanagement, excessive risk and speculation, overzealous business expectations, diminishing margins, and adverse political/economic conditions (domestic and international). Leaving aside economic and political factors, much of which are directly or indirectly linked to bad governance.[15]

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[13] Lee M, 'Hong Kong Lehman Brothers Investors Protest' *The China Post* (China), 24 August 2009; 'Lehman Collapse Causes Hong Kong Hangover' (2008), http://www.chinesestock.org/show.aspx?id=20605&cid=8 viewed 5 July 2010.

[14] Financial Services and Treasury Bureau, *Review of Corporate Rescue Procedure Legislative Proposal: Consultant Paper* (2009) p 2, http://www.fstb.gov.hk/fsb/topical/review_crplp.htm viewed 29 October 2009.

[15] Finch V, *Corporate Insolvency Law: Perspectives and Principles* (2nd ed, Cambridge University Press, UK, 2009) , p154-60.

Since the heart of corporate governance lies with the board of directors,[16] they are culpable for the bad governance of a company. In business risk cannot be eliminated, it is part and parcel of commerce. Even though risk is a bigger problem for some sectors like the financial sector, directors have to monitor them.[17] Underscoring this obligation is the directors' duty to exercise care, skill and diligence. If mismanagement led to the collapse of a company, the directors of that company failed to exercise this duty.

Unlike insolvency where the interest of creditors is paramount, in corporate rescue directors have to strike a balance between shareholders, creditors, and employees. The cooperation and compromise amongst the various stakeholders is vital to a successful outcome and the director plays a key role in dealing with these stakeholders during this critical period.[18] It is also important to note that corporate rescue is not about assigning blame. It is about swift decisions and actions to save a company at the brink of insolvency. Hence, it is important to ensure directors act at the first sign of financial distress. Even thought there is a general duty for directors not to trade while insolvent or near the point of insolvency, statutory obligations to include a positive duty to prevent insolvent trading makes its mandatory for directors to act and put in place preventative measures. The introduction of such statutory obligation will extend the idea of corporate rescue procedures as part of a director's duties (see figure 1 below). This is also one of the major reasons why the Hong Kong government is keen on enacting this statutory duty.

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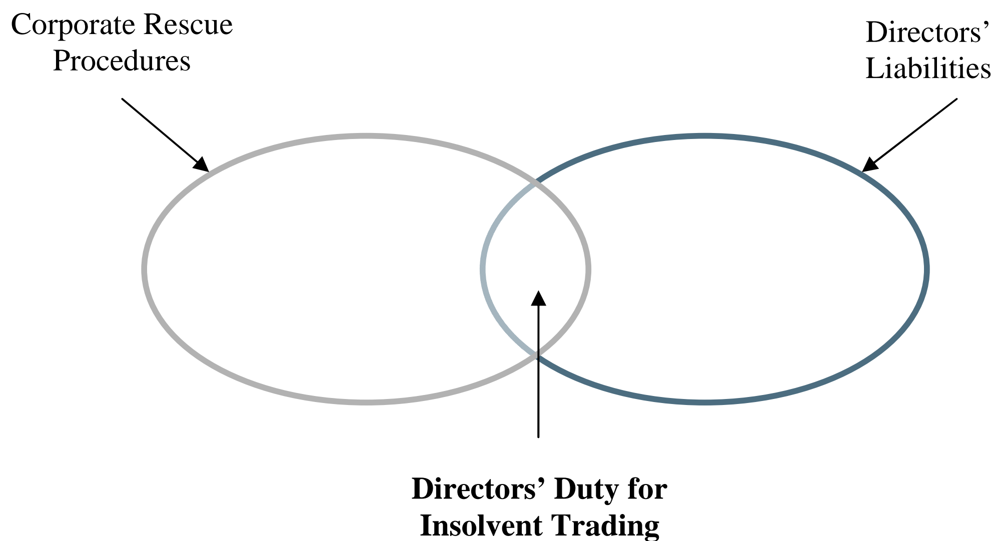
[16] Du Plessis J, McConvill J and Bagaric M, *Principles of Contemporary Corporate Governance* (Cambridge University Press, Port Melbourne, 2005) p 53.
[17] Bob Tricker, *Corporate Governance: Principles, Policies, and Practices* (Oxford University Press, New York, 2009) pp 329-333.
[18] Harris J, 'Director Liability for insolvent Trading: Is the Cure Worse than the Disease?' (2009) 23(3) *Australian Journal of Corporate Law* 266.

Figure 1



EXISTING STATUTORY OBLIGATIONS

At present, a company director in Hong Kong can be held accountable for trading in solvently under two statutory obligations: fraudulent trading or disqualification of unfit directors.

Fraudulent Trading

Section 275 of the Companies Ordinance (CO) confers personal liability for any persons (directors) who traded with intent to defraud creditors would be held personally liable. This obligation was based on the laws transplanted from the territory's former colonial rulers. It was

modelled on the UK's fraudulent trading provisions found in section 213 of the *Insolvency Act* 1986 (UK).

Under section 275(1) of CO:

> If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the Official Receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

Persons liable under section 275 can consist of current or past directors (this includes shadow directors and parent company).[19] If the court found the directors of a company to have contravened this section, they could be liable for the debt incurred when the company was trading during insolvency.[20]

In the prolix case of *Aktieselskabet Dansk Skibsfinansiering v Brothers* [2000] 1 HKC 511, the court averred that until the enactment of corporate rescue laws in Hong Kong, "fraudulent trading"[21] remains the only mechanism to avail the court to impose personal liable on directors for insolvent trading. Even so, the standard of proof remains a cumbersome hurdle for the aggrieved to receive justice. Apart from the issue of determining when the point of insolvency

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[19] Kwan P, *Hong Kong Corporate Law* (Longman, Hong Kong, 2006) p141.
[20] Kwan, n20, p 144.
[21] *Companies Ordinance* (Cap.32) (Hong Kong), s275.

arises, to prove "defraud" and "fraudulent purpose" there must be actual dishonesty, misrepresentation, and personal gains of directors.[22] Furthermore, "to defraud" involves a subjective intention of dishonesty, which must be satisfied and not mere speculation.[23] This statute sets to "a high bar" for creditors or liquidators to take legal action against former directors of insolvent companies in Hong Kong.

Disqualification of Unfit Directors

Section 168H of CO is also one of the most common legal actions faced by directors for trading while insolvent. This provision stipulates ground for disqualifying unfit directors. It states if;

> [a]t any time [the company] become insolvent whether while he was a director or subsequently; and that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or companies, makes him unfit to be concerned in the management of a company.[24]

In the case of *Official Receiver v Ng Ting Ming* [2008] HKCU 331, the Court held that the managing director, Ng, has breached his duty by allowing the continuation of trade for a whole year after a sum of about HKD $9,000,000 debt was accumulated exceeding the company's assets by about HKD $7,800,000. The court held Ng whom signed the audited accounts knew about the financial status of the company has allowed it to continue trading and mismanaging the company causing its demise. However, the court did not deal with the liabilities incurred by the company while trading in solvently.

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[22] Kwan, n20, pp138-140.
[23] See Re Patrick and Lyon Ltd [1933] Ch. 786 at 790-792 per Maugham J
[24] *Companies Ordinance* (Cap.32) (Hong Kong), 168H (1) (a) and (b).

Even though disqualification of directors prevent these unfit directors from causing financial harm to future creditors by disallowing them to manage companies, it is does not provide actual relief for past creditors. At the minimum, directors should be responsible for their own risky decisions. Hence, the importance of risk management and accountability calls for legal duties to be put in place to prevent insolvent trading as a remedy to put a stop to directors from either recklessness or failed to act.

In a Hong Kong landmark case, *Chingtung Futures Ltd. (In liquidation) v Lai Cheuk Kwan Arthur and Others* [1992] 2 HKC 637, Lai was the chairman of Chingtung and when the company went into liquidation after the 1987 stock market crash. The company had incurred a debt from than HKD $83,977,986. The liquidator brought an action on behalf of the company claiming that Lai had breached his duty of care by taking on excessive and unreasonable risk. Lai was found to have speculated on shares by hedging on the shares positions on Hang Seng Index.[25] Mr Lai was ordered to pay damages to the company of HKD $83,977,986. The ratio of the case was stated by Bokhary J (at 151):

> Where any director or directors so fail to take reasonable care to protect a company as to expose it to a risk of insolvency, and the company becomes insolvent as a result and therefore goes into liquidation, then, if any creditor of the company suffers loss and is driven to proving in the liquidation for redress, the company's claim against the negligent director or directors cannot be defeated, to the ultimate detriment of any creditor, by any ratification which such director or directors may be able to procure of their own negligent acts or omissions .

[25] *Chingtung Futures Ltd. (In liquidation) v Lai Cheuk Kwan Arthur and Others* [1992] 2 HKC 637 at 111.

Even if codification was a re-statement of general law duties, it could help educate directors like Mr Lai to act sooner at the first signs of trouble instead of allowing financial problems to fester, or thinking that one could trade out of difficult times.

In the UK, the statutory obligations imposed on directors for wrongful trading provision was proven to be necessary as general law obligation did not provide incentives for directors to prevent trading whilst insolvent. Prior to the enactment of the Insolvency Act 1986, legal action against directors for trading while insolvent could only be brought under general law on fraudulent trading.[26] In the case of *R. v Grantham*[27] it was held that for a prosecution of fraudulent trading, dishonesty must be present and thus there must be evidence to demonstrate a positive intent of the directors to defraud creditors.[28] In contrast, litigation under s.214 of the Insolvency Act 1986 is less onerous. For example, in the case of *Re DKG Contractors Ltd* [1990] BCC 903, the company director was sue for breach of director's duty, as there was no reasonable prospect of avoiding liquidation. The court held that, "the method of operating the company meant that its assets were not preserved for its general creditors at a time when the company was of doubtful solvency". Furthermore, the wrongful trading provision had an effect on directors' behaviour by obliging them to take positive steps to avoid insolvent trading. This is another motivation for Hong Kong to follow suit.

[26] Predecessor Fraudulent Trading provision to s213 Insolvency Act 1986 (UK) and s275 Companies Ordinance (HK)
[27] [1984] Q.B. 675,
[28] S332 Companies Act 1948 (UK)

EARLIER ATTEMPTS TO INTRODUCE DIRECTOR'S LIABILITY TO AVOID INSOLVENT TRADING IN HONG KONG

In 1990 the Attorney General and Chief Justice of Hong Kong referred the issue of reviewing, the law and practice relating to insolvency laws of both individuals and bodies corporate to the Law Reform Commission of Hong Kong (LRC) on 14th September.[29]

The LRC report on insolvency and corporate rescue was released in October 1996. It stated that,

> The purpose of an insolvent trading provision would be to encourage responsible persons to face the fact that a company was slipping into insolvency at an early date and cause them to address the situation rather than to trade on regardless of the consequences. Insolvent trading should raise the awareness of responsible persons of their duty to creditors rather than just having regard to the interests of the shareholders. Responsible persons who paid attention to their business, and who took appropriate action when faced with insolvency, should never face an application in respect of insolvent trading, whereas those who did not would be vulnerable.[30]

As discussed earlier in *Official Receiver v Ng Ting Ming* [2008] HKCU 331, the respondent was an unfit director because he was, *'unable to handle corporate affairs in any responsible or law-abiding manner'*. [31] In the judgement, the court reiterated the contains of the LRC report in 1996 stating that,

> [i]t is very important to bear in mind that as the director of a company he has a very important duty to strictly comply with the accounting duties imposed on him. It is because without sufficient accounting

[29] The Law Reform Commission of Hong Kong, 'Report on Corporate Rescue and Insolvent Trading' (1996) http://www.hkreform.gov.hk/en/docs/rrescue-e.pdf ,viewed 10 July 2010.
[30] The Law Reform Commission of Hong Kong, n38, at 19.7.
[31] *Official Receiver v Ng Ting Ming* [2008] HKCU 331 at 32.

> records, any directors cannot act responsibly in making decisions whether to continue trading In my view, it is likely that it is as a result of the respondent's failure to keep proper accounts that led to the commission of the other misconduct such as insolvent trading. [32]

Much of the substance in the LRC 1996 report was based on the experiences of in the UK and the statutory provisions in the UK's *Insolvency Act 1986*, Australia's *Corporations Act 2001* (Cth) and the US's Chapter 11, *Bankruptcy Code*.[33] For historical reasons (Hong Kong was a former British Colony) as well as continuity, LRC's recommendations on directors' liability for insolvent trading was based largely on the UK's section 214, *Insolvency Act 1986* on wrongful trading and the recommendations of the UK Insolvency Law Review Committee, *Insolvency Law and Practice* (Cmnd 8558, June 1982) (generally referred to as "the Cork Report").

Briefly, section 214 of *the Insolvency Act 1986* (UK) is applicable to the responsible director when the company has (i) gone into insolvent liquidation; and (ii) at sometime prior to the commencement of the winding up, the director had knowledge of the company having no reasonable prospect of avoiding insolvent liquidation unless the director took every step possible to minimise the loss suffered by creditors. [34] The UK provision can be distinguished from Hong Kong's policy objectives as it an aggregation of responsibilities when the company is insolvent and being wound up. According to Keay, '*[r]egulating directors through the use of section 214*

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[32] *Official Receiver v Ng Ting Ming* [2008] HKCU 331 at 28.
[33] The Law Reform Commission of Hong Kong, n 38, at 1.8-1.10.
[34] *Insolvent Act* 1986 (UK), s 214 (3).

was an attempt to stop directors from externalising the cost of their companies' debts and placing all of the risks of further trading on the creditors.' [35]

In comparison to the LRC's proposed section of 295C to be inserted in CO will make directors and senior management[36] personally liable for trading during insolvency if he/she:

> (a) knew or ought reasonably to have known the company was insolvent or knew or ought reasonably to have known that there was no reasonable prospect that the company could avoid becoming insolvent; or (b) there were reasonable grounds for suspecting that the company was insolvent or there was no reasonable prospect that the company could avoid becoming insolvent, And the director failed to take any steps to prevent the insolvent trading. [37]

The proposed section aims to impose personal liability on directors and senior management who allow or failed to take steps to prevent the company from insolvent trading. Furthermore, the LRC report recommended that the power to make an application to the court against a director or senior manager should be vested in a liquidator. And that directors and senior management should be liable to pay compensation if the company traded while insolvent. A defence could be mounted if a responsible director and senior manager established that he or she had warned the board about insolvent trading and was opposed the course of actions the company had taken.[38]

[35] Keay A, "Wrongful trading and the liability of company directors: a theoretical perspective" (2006) 25 Legal Studies 3, pp 431-461.
[36] See Hong Kong Legislative Council, n1, "reasonable person" in the definition of the proposed Bill
[37] Hong Kong Legislative Council, n1.
[38] The Law Reform Commission of Hong Kong, n37, at 10.7.

In January 2000, a CO (Amendments) Bill was presented to Legislative Council. A new section called 295C was to be inserted in CO, but the Bill was removed for consideration because there was insufficient time for the Legislative Council to resolve the controversial issues contained in the Bill. A second attempted in May 2001, this time the Bill was retitled as the Companies Ordinance (Corporate Rescue) Bill 2001 (CCR Bill). The CCR Bill was allowed to lapse in 2004 as it was not possible to complete the scrutiny of the Bill in the select committee before the end of the Legislative Council term.[39] The underlying problem was that there were the diverse views among stakeholders, particularly on how to deal with employees' outstanding entitlements, and the Bill was allowed to lapse.[40]

In 2006, Rogers VP commented in his dicta in the case of *Re Legend International Resorts Ltd* [41] that it is not the court's duty to legislate but read existing laws, nevertheless he inferred that law reform on corporate rescue and insolvency was long overdue.[42] His honour stated that:

> In the Report on Corporate Rescue and Insolvent Trading by the Law Reform Commission of Hong Kong published in October 1996, recommendation was made for the introduction of a law which would enable corporate rescues to take place far more conveniently than at present. Even now, nearly 10 years later, no such law has been enacted. It is not appropriate for this court to examine the reasons why no such law has been introduced.[43]

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[39] Financial Services and Treasury Bureau, n15, at 8.
[40] Financial Services and Treasury Bureau, n15, at 8.
[41] [2006] HKCU 357
[42] His honour also agreed with the views of Yuen J in Re Keview (BVI) Ltd [2002] 2 HKLRD 290 and from *Re Luen Cheong Tai International Holdings Ltd* [2003] 2 HKLRD 719.
[43] *Re Legend International Resorts Ltd* [2006] HKCU 357 at 33

Evidently without such legislation the court is unable provide remedies to aggrieved creditors if the directors had exploited the interests of the creditors but falls short of breaching section 275 of CO for fraudulent trading.

CURRENT PROPOSALS ON DIRECTORS' LIABILITY FOR INSOLVENT TRADING

In October 2009, a Consultation Paper was released to seek public input on the proposed statutory obligations due to be tabled to the Legislative Council by the end of 2010 for consideration. Earlier the FSTB with the Official Receiver's Office was instructed by the Hong Kong government to review the submissions and identify key objections of the stakeholders on the Bills in 2000 and 2001.[44] The new proposed legislation was based on the 2001 CCR Bill.

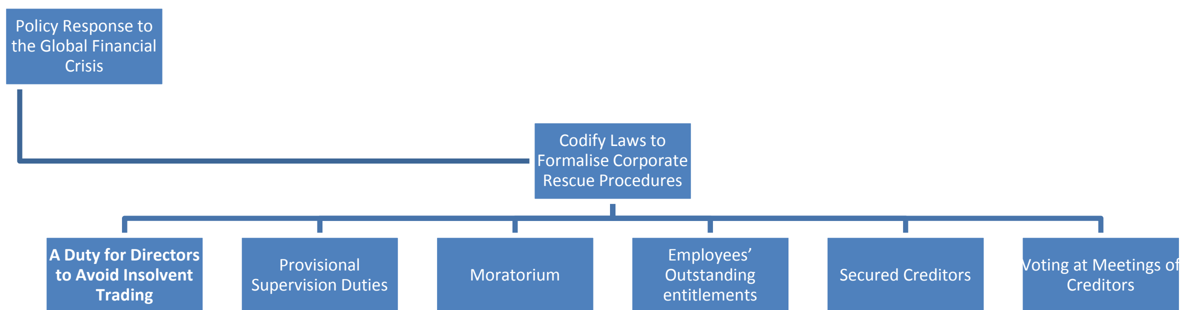
Using the Global Economic Crisis as a pretext, the government is reintroducing legislation to formalise and regulate corporate rescue procedure. The Consultation Paper stated the proposed legislation is relevant to the recent global financial crisis as,

> The procedure [Corporate Rescue Procedures] would be particularly helpful in reducing the stress to the economy when a greater number of companies with viable business for the longer term face more immediate and short term financial difficulty in a cyclical economic downturn. It would be beneficial to the company's shareholders and creditors who might in due course get a better return from the success of the rescue plan than from the outcome of a winding up. It would also be beneficial to the company's employees as well as suppliers and contractors for that portion of employment and purchases that might be retained by the rescue.[45]

[44] Financial Services and Treasury Bureau, n15, at 8.
[45] Financial Services and Treasury Bureau, n15, at 9.

As part of this legislative package, directors ought to be compelled to act earlier rather than later so as to avoid corporate insolvency. The diagram below (figure 2) illustrates the policy objectives set out in the legislative proposal. Directors' duty to avoid insolvency is one of 6 key issues that will be regulated.

<u>Figure 2</u>



In the Consultation Paper the government reiterated the substance of the 2001 Bill by noting the following,

> The insolvent trading provisions were intended to be applicable to companies in general and not only in the context of provisional supervision. However, these provisions would in effect serve as an incentive to

induce responsible persons to initiate provisional supervision earlier, rather than resorting to insolvent trading before liquidation.[46]

More importantly, the Consultation Paper made some amendments to the wordings of the proposed legislation because:

> During scrutiny of the 2001 Bill, some stakeholders from the business sector expressed concerns that the insolvent trading provision would discourage directors and senior management from taking any risk and would not be conducive to business operations. Having reviewed this issue, and having made reference to the regimes in other jurisdictions, we remain of the view that some form of insolvent trading provision is needed to complement provisional supervision by encouraging directors to act on insolvency earlier rather than later to prevent further erosion of the distressed company's assets at the detriment of creditors.[47]

To address the business sector's concerns, Consultation Paper made two adjustments to the insolvent trading provision first is to exclude senior management from being liable under insolvent trading, and second to modify the standard in establishing liability.

On the first amendment the FSTB stated in Consultation Paper that:

> Notwithstanding the LRC's recommendation in this regard, we consider that there will unavoidably be questions as to who is a "senior manager". We have also made reference to the insolvent or wrongful trading provisions in other major common law jurisdictions, such as Australia and the UK, and note that the relevant provisions in those jurisdictions do not cover senior managers. We therefore consider it appropriate to retain liability for directors (including shadow directors), while exempting senior management from being liable for insolvent trading.[48]

On the second matter, it stated that:

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[46] Financial Services and Treasury Bureau, n15, at 33.
[47] Financial Services and Treasury Bureau, n15, at 33-34.
[48] Financial Services and Treasury Bureau, n15, at 34.

> Among the grounds to establish liability for insolvent trading… we propose dropping ground (1)(b) [section 295C] to impose a higher standard in establishing liability so as to address the business sector's concerns. As a result, responsible persons will only be held liable if they knew or ought reasonably to have known the company was insolvent or knew or ought reasonably to have known that there was no reasonable prospect that the company could avoid becoming insolvent. A reasonable suspicion of the company's insolvency will not suffice.[49]

On the 9th of July 2010, the Hong Kong government released the Consultation Conclusion which took into account some 59 submissions about the proposals in the October 2009 Consultation Paper.[50] The Consultation Conclusion Paper found that,

> [a]n overwhelming majority of responses supported the introduction of insolvent trading provisions, including many of those from the business sector and practitioners. Some submissions noted that the introduction of insolvent trading provisions would encourage directors to act on insolvency earlier and would enhance corporate governance. One submission suggested that it should be made clear that a company trading while undergoing corporate rescue should not result in insolvent trading liability for its directors and provisional supervisor.[51]

In addition, the conclusion paper also uncovered that,

> Among the minority dissenting submissions, which were from the business sector and practitioners, there were concerns that insolvent trading provisions would deter directors from taking risk and that it might be too easy for companies to be caught by insolvent trading provisions.[52]

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[49] Financial Services and Treasury Bureau, n15, at 34.
[50] Financial Services and Treasury Bureau, n15, at 1.
[51] Financial Services and Treasury Bureau, n15, at 24.
[52] Financial Services and Treasury Bureau, n15, at 24.

The public submissions were categorised into three areas. Firstly, there was overwhelming majority of public support for the two proposed amendments. But the Conclusions Paper noted that,

> A few submissions, who were from the business sector and practitioners, suggested that a defence should be provided for directors who had acted reasonably and honestly.[53]

Secondly, those who did not support the proposed formulation expressed concerns that dropping the ground "reasonable grounds for suspecting" in establishing liability would make the insolvent trading provisions too weak and would undermine the effectiveness of the provisions.[54] This notation was from our submission in dated the 30th December 2009. We made the following argument:

> Without reasonable suspicion, if the director knew or expect insolvency is to happen in due course, it would seem too late for the director to act in 'prevention'. Without this heightened alert, we contend that it is unfair to ask directors to act in such a short time frame (almost too late) and hold them personally liable. By acting earlier- that is, as soon as any suspicion occurs, it gives directors some sort of guidelines to act as soon as possible. We hold the view that the sooner they act, the more they can resolve in the light of corporate rescue. Upon suspicion, one would require positive action of prevention of insolvent trading from happening at an earlier stage. When insolvency actually happens then it is too late. Often the time is of essence when determining insolvency and when a range of events unfold. Therefore, it is necessary for 'suspecting insolvency' to work hand in hand with prevention.[55]

We took the definition of "suspect" from the Australian case, *Queensland Bacon v Rees Pty Ltd* (1966) 115 CLR 266, Kitto J held that suspect was *'more than a mere idle wondering whether*

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[53] Financial Services and Treasury Bureau, n15, at 25.
[54] Financial Services and Treasury Bureau, n15, at 25.
[55] Young A and Chu T, Submission to the Financial Services and Treasury Bureau in response to '*Review of Corporate Rescue Procedure Legislative Proposal: Consultant Paper*' (2009), http://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp/Angus%20Young%20&%20Tina%20Chu.pdf ,viewed 12 July 2010.

[insolvency] exists or not, it is a positive feeling of actual apprehension or mistrust, amounting to a slight opinion, but without sufficient evidence.'[56]. Also in *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699, Einfeld J held that reasonable grounds to suspect,

> *must be judged by the standard appropriate to a director of ordinary competence*.'[57]

Using these definitions as a basis, the draft subsection would only require that any prudent director must investigate further into the likelihood of insolvency, if he or she believed that there were sufficient grounds to do so. This should be a matter of course for good business risk management practices and should not discourage directors from taking calculated business risks, and in our opinion is an unfounded justification by the business community searching for any reason to reject increased director responsibility.

On the third issue, the Conclusion Paper stated that,

> One of the proposed constituent elements of insolvent trading was "failure to take any steps to prevent insolvent trading". There were suggestions that the word "any" in proposed section 295C(1)(c) of the consequential amendments to the Companies Ordinance in the 2001 Bill should be replaced by the word "all".[58]

The Hong Kong government's responses to the above are to:

1. exclude senior management from liability under insolvent trading;

[56] *Queensland Bacon v Rees Pty Ltd* (1966) 115 CLR 266.
[57] *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699 at 703.
[58] Financial Services and Treasury Bureau, n15, at 25.

2. modify the standard in establishing liability by dropping “reasonable grounds for suspecting”, and;

3. rephrases the text from “failed to take any steps to prevent insolvent trading” to “failed to prevent insolvent trading”.[59]

In spite of the compromises the Hong Kong government have to accept, after ten years in waiting, with the majority submissions positive about the amended provisions to the previous proposals contained in the CO (Amendments) Bill 2000 and the CCR Bill 2001, the government is planning to submit a Bill to the Legislative Council in the current seating by the end of this year.

CULTURAL DIMENSIONS

As noted earlier Hong Kong’s economy is dominated by Chinese family-owned and controlled companies. Unlike large companies where Anglo-American governance practices and management methods are adopted, many of these Chinese family-owned and controlled companies, usually small to medium sized are governed principally by traditional Chinese values and beliefs. These cultural values and beliefs are deeply rooted in the teachings of Confucius,[60] and they practice paternalistic governance, reminiscent of the hierarchic pattern of control based on the family patriarchy.[61]

[59] Financial Services and Treasury Bureau, n15, at 26.
[60] Tomasic R and Little P *Insolvency Law and Practice in Asia* (Pearson, Hong Kong, 1997) 3
[61] Redding, n6, pp. 43, 156-68.

The head of these companies see themselves as "big boss" (*lau pan*) and their decisions do not need any explanation, or be subjected to any scrutiny by other members of the board.[62] If father or mother is the CEO/Chair of the company, the children who might be members of the board of directors are answerable and subservient to the family patriarch and not the company. This practice originates from the Confucian doctrine of filial piety (*xiao*) where children must be above all else, be obedient to their parents.[63] If there are relatives on the board, the head of the company is usually the most senior member of the extended family. Members of the board are expected to have questionable loyalty (*zhong*) to the chair/CEO and not the organisation.[64] But how does will this impact on insolvent trading provisions?

First, the key decision-maker is the CEO/Chair and not the board, so the family patriarchy will take it upon himself or herself not to let the company go under. This could mean allowing the company to continue to trade whilst being insolvent. The empirical research suggest that there is still a little stigma attached to corporate insolvency and personal bankruptcy because this would mean a "loss of face" for the family.[65] Since the Chinese business culture puts a lot of emphasis on personal reputation and trust, if the family business goes into liquidation, the loss of trust (*xing*) and face (*mianzi*) will negatively affect members of the family future business endeavours. This is because the tainted reputation from corporate failure would affect the business community willingness to deal or associate with them.[66]

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[62] Mead, R. *International Management: Cross-Cultural Dimensions* (3rd ed., Blackwell, Oxford, 2005) pp. 278-9.
[63] Redding, n6, p.59.
[64] Chen M *Inside Chinese Business: A Guide for Managers Worldwide* (Harvard Business School Press, Boston, 2001) 27-30
[65] Tomasic R and Little P, n60, p 124
[66] Tomasic R and Little P, n60, pp 124-6

Second, in Hong Kong's business dealings amongst close knitted family-owned companies are common, personal relationships tend to prevail over legal rules because they have been doing business for many years, some even for generations. These companies often shy away from the law. In part due to the Confucian tradition avoiding confrontation or the use of the law to settle disputes. Negotiations and compromises are instead preferred. This suggests laws are noting more than "paper tigers" – empty symbolism.[67] Kamarul and Tomasic observed that:

> [i]n Hong Kong, insolvency law is used mainly by foreign creditors and corporations, and rarely by Chinese businesses ... Chinese businesses, however, use the legislation as it is perceived to be based on foreign laws, rather than on Chinese social tradition ... According to one major international accounting firm, in Hong Kong, 'there has been little purely Chinese insolvency. We are involved with foreign investors who come un stuck. Chinese families stick together generally, except where they want to make an example of someone or recognise the situation is beyond their collective means.' An expatriate accountant said, of the solvency law, that 'we have an English system imposed on Hong Kong, which does not necessarily reflect how Hong Kong works. The Chinese system is one of self-reliance, where people aim to solve their problems themselves you keep it within the family'.[68]

CONCLUSION

From the LRC report to a legislative proposal with a fighting chance to pass the Legislative Council, the Hong Kong had to wait more than ten years to achieve this policy objective. Whether is it the question of timing – post GFC climate, or the patience and determination of the government to get this Bill through to become law? Yet this question is not that important, what is significant or momentous is that after ten years in waiting two failed attempts, it is finally

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[67] Lau A, Nowland J and Young A, "In Search of Good Governance for Family Listed Companies: A Case Study on Hong Kong" (2007) 28 *Company Lawyer* 306 at 309

[68] B. Kamarul and R. Tomasic, "The Rule of Law and Corporate Insolvency in Six Asian Legal Systems", in Kanishka Jayasuriya (eds.) *Law, Capitalism and Power in Asia* (Routledge, London, 1999) p 151 at 167

going to get this Bill passed at the end of this year. However the comprises the government had to take on board made the proposed provision less stringent. The standard of care for directors had been lowered from "reasonable grounds for suspecting" in establishing liability to the present - directors are liable if they knew or ought reasonably to have known the company was insolvent or knew or ought reasonably to have known that there was no reasonable prospect that the company could avoid becoming insolvent. This was obviously a political choice not a legal one, but this does not diminish the need for higher standards for directors' positive duties, requiring them to act at the first sign of financial distress.

We came to the conclusion that this is a sub optimal choice. When compared to the Australian statutory obligations section 588G of the *Corporations Act 2001* (Cth), the proposed standard of liability for directors is much lower. Therefore, the incentive for directors in Hong Kong to avoid trading insolvency is not sufficient for the objectives in the proposed provision to be realised. We hold this view in spite the fact that Australia is currently rethinking its strict approach by proposing a safe harbour alternative, moratorium or preserving the status quo.[69]

On another level, there is also cultural factor in Hong Kong. Whilst we think that insolvency law reform is a positive and necessary step for Hong Kong government and the business community to take, its impact and effectiveness would vary according to cultural orientation and values held by the executives and owners. For Chinese family-owned and controlled, usually small to mid sized companies, transplanting Western laws to regulate these types of companies might not be

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[69] Federal Treasury, "*Insolvent Trading: A Safe Harbour for reorganisation attempts outside of external administration*", (2010) [4.1.1] <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/004.htm&pageID=003&min=ceba&Year=&DocType= >

appropriate.[70] Nevertheless, this does not negate from the fact that the enactment of corporate rescue procedures in Hong Kong by the end of this year is a momentous achievement for the Hong Kong government.

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[70] Lindsey T "Culture, Insolvency and Legal Orientalism in Asia: Researching for Goering's Revolver" in Roman Tomasic (ed.) *Insolvency Law in East Asia* (2nd ed., Ashgate, Aldershot, 2006) p 509 at 515