



**Review of the Role of the
Official Receiver's Office
Consultation Paper**

FINANCIAL SERVICES BUREAU



June 2002

Abbreviations

ASIC	Australian Securities and Investments Commission
BO	Bankruptcy Ordinance (Cap 6)
CO	Companies Ordinance (Cap 32)
EOUST	The Executive Officer for U.S. Trustees
FSB	Financial Services Bureau
HKORO	Hong Kong Official Receiver's Office ¹
HKSA	Hong Kong Society of Accountants
HKSARG	Hong Kong Special Administrative Region Government
HK\$	Hong Kong Dollar(s)
IEFAS	Insolvency Estate Funds and Accounting System
IOs	Insolvency Officers
IPAA	Insolvency Practitioners Association of Australia
IPCU	Insolvency Practitioner Compliance Unit
ITSA	Insolvency and Trustee Service Australia
IVA	Individual Voluntary Arrangement
LIPs	Licensed Insolvency Practitioners
LRC	Law Reform Commission
MIS	Management Information System
MSA	Management Services Agency
OR	Official Receiver
ORO	Official Receiver's Office
ORMIS	Official Receiver's Management Information System
PIP(s)	Private Sector Insolvency Practitioner(s)
RIPs	Registered Insolvency Practitioners
RPBs	Recognised Professional Bodies
UK	United Kingdom
US/USA	United States of America

¹ In common with many jurisdictions, the Official Receiver is a personal appointment. A number of the functions and powers exercised by the Official Receiver's office are technically speaking those of the individual OR. A distinction could be drawn between the HKORO and the OR in this respect, particularly when making references to statute. However, the actions and responsibilities of the office are commonly seen as being a departmental rather than individual matter. This study examines the role of the entire department rather than drawing a technical distinction between the different legal status of the OR and his department. As such, the term HKORO is used throughout the paper to refer to both the department collectively and to the actions, powers and duties of the OR, as carried out by his department staff.

FOREWORD

This consultation paper invites comments from the public on the outcome of a consultancy study on the role of the Official Receiver's Office in insolvency administration.

The Financial Services Bureau has commissioned the study with a view to reviewing the existing role of the Official Receiver's Office in the provision of insolvency administration services and identifying what future role it should play, and what changes need to be made to its present modus operandi against the future role.

This paper sets out the findings and recommendations of the consultants. We would be grateful for comments from the public on them. Comments should be sent no later than 31 August 2002 to:

Financial Services Bureau
18th Floor, Tower 1, Admiralty Centre,
18 Harcourt Road
Hong Kong
or faxed to 2528 3345, or emailed to elee@fsb.gov.hk.

Requests to treat all or part of a response in confidence will be respected. Should no such request be made, the Financial Services Bureau will assume that the response is not intended to be kept confidential.

The views expressed in the consultation paper are those of the consultants. The Financial Services Bureau has not taken a position on any of the consultants' conclusions and recommendations and will not do so before assessing the public's views on the paper.

Financial Services Bureau
June 2002

Introduction

1. The provision of an effective and internationally comparable insolvency service is an essential component in maintaining Hong Kong's position as a major international business and finance centre. However, the role of the HKORO in ensuring the provision of such a service is based on legislation introduced at a time when the insolvency environment was very different and the caseload was considerably lower.
2. The current insolvency and bankruptcy regime in Hong Kong, and the HKORO's role within it, is largely based on amendments to the UK's 1914 Bankruptcy Act and the UK's 1929 Companies Act. The substantive overhaul and consolidation of insolvency law that has taken place in the UK subsequently has not occurred in Hong Kong. Whilst there have been some revisions to the legislation in recent years, it is arguable that these have been piecemeal and have not comprehensively addressed the changing insolvency environment or developments in insolvency in other major jurisdictions.
3. In addition to the impact of the 1997 Asian financial crisis, there has been an expansion in the availability and use of consumer credit common to many jurisdictions. Insolvencies, both personal and corporate, have been on the rise, causing a major increase in caseload at the HKORO. This trend has been accompanied by a shift from a largely manufacturing-based economy to a more service-oriented economy. This is likely to significantly reduce the tangible assets available in corporate insolvencies, increasing the risk of assets being insufficient to meet the costs of administration. On the personal bankruptcy side, consumer credit bankruptcies typically involve minimal assets. The increased volume of such insolvencies has emphasised the importance of a well-developed and efficient system for dealing with insolvencies where there are insufficient assets to fund the cost of the administration of cases.
4. The HKORO has taken measures to try and address the additional pressures it faces by introducing new approaches, such as the outsourcing schemes utilising the Administrative Panels and latterly the tender scheme. However, in view of the above, the HKORO considers that a fundamental review of its role and funding is appropriate. Arthur Andersen ("the Consultant") was accordingly appointed by the Financial Services Bureau ("FSB") to undertake a review of the role of the Official Receiver's Office in Hong Kong ("HKORO").

1 Role and Functions of the Official Receiver's Office

Issues identified — An ORO body is critical in ensuring an effective insolvency service

- 1.1 Any economy that operates on credit has to deal with insolvencies, both personal and corporate, that are an inevitable part of the system. It is important to the credibility of the credit system and the smooth functioning of the market that such insolvencies are dealt with efficiently and effectively. This promotes business confidence, recycles assets frozen in the insolvent estates, and provides appropriate checks and balances against the misuse of credit. Such systems usually provide for an independent and appropriately qualified party to administer the insolvent estate.
- 1.2 Given the importance of insolvency infrastructure in ensuring an efficient and effective means of handling insolvencies, it is common for governments to establish public bodies to ensure that an effective insolvency service is provided. Such bodies typically address issues that would not be dealt with adequately if left to the private sector, or are more appropriately dealt with by a government or independent body e.g. regulation of the private sector, or law enforcement.
- 1.3 The private sector would not normally provide a service where there are no assets, or insufficient assets to meet the costs of their administration (commonly referred to by the HKORO and in the consultation paper as “summary” cases). This is where the concept of a “last resort” service comes in. Recognising the importance of an orderly resolution of all insolvencies, most developed insolvency jurisdictions arrange for an insolvency practitioner of last resort. This is a mechanism to ensure that a basic level of insolvency service will be provided in every case, regardless of asset coverage. Either a government body provides the service, or such a body oversees regulations that ensure that the private sector will provide the service.
- 1.4 Without such a service, Hong Kong's practice would be significantly out of line with comparable jurisdictions, and the credibility of its insolvency and credit system would suffer accordingly. Given its central importance to the smooth conduct of insolvencies and the reputation of Hong Kong's market, the HKORO's role in ensuring (but not necessarily providing) the provision of a last resort service was used as a working assumption for the study.

Key Findings

i. HKORO's functions consistent with those typically provided by OROs

- 1.5 The study examined the role performed by ORO type bodies in other jurisdictions, commenting specifically on those in the benchmark jurisdictions of the UK, US and Australia. Whilst the precise functions and means of delivery varied between jurisdictions, in broad terms their functions consistently fell within the following three categories:
 - **Administration of cases** where the assets in the cases are insufficient to meet the costs of doing so (the “**last resort**” function) — Note that although an ORO is charged with ensuring that the service is provided,

it may not carry out the casework itself, which may be handled by the private sector (see further discussion below).

- **Enquiry and enforcement** — This would involve basic checks to ensure that there has been no obvious breach of insolvency law or misappropriation of assets, and taking action where there has been. This is essential to maintaining market discipline and protecting society against the reckless use or abuse of credit. As such activity is not guaranteed to generate additional assets, PIPs may be reluctant to carry out this role. An ORO may as a matter of public interest take on some or all of the responsibilities for investigation and enforcement of possible offences.
- **Regulation and supervision** — As the effectiveness of the insolvency service relies on the combination of PIPs and ORO activities, in some jurisdictions the ORO has responsibility for regulating the provision, quality and costs of insolvency services provided by PIPs. This may focus on cases where PIPs deliver the last resort function, or extend to court supervised insolvency, with the ORO effectively acting as an officer of the court.

1.6 The services provided by the HKORO also fall under these general categories. In particular, the HKORO is obliged to provide a last resort function. The OR is appointed by the Court to act as trustee or liquidator under the Bankruptcy Ordinance (“BO”) and the winding up provisions of the Companies Ordinance (“CO”) respectively where no PIP is nominated and willing to take the position. In addition, it has responsibilities for enquiry and enforcement in both liquidations and bankruptcies. Whilst its regulation and supervisory responsibilities are not as wide ranging as in some jurisdictions, it does have some loosely defined responsibilities under the CO for PIPs conducting compulsory liquidations. The HKORO’s supervision of the Panel A and tender schemes, combined with the high proportion of court based insolvencies, also gives the HKORO extra-statutory authority and influence on the PIP sector in Hong Kong.

1.7 The study found that the roles currently carried out by the HKORO are consistent with commonly accepted practices for similar bodies, including those in benchmark jurisdictions. The study concluded that there was no reason to change the general areas of service provided. Rather, it concentrated on issues affecting each of the service areas identified, and possible options for enhancing or varying the means by which the HKORO sought to provide these in Hong Kong.

ii. Critical distinction between ensuring service and delivery of the service

1.8 The study noted that a major distinction between the benchmark jurisdictions examined lies in the approach to the last resort function. All three jurisdictions offer a last resort function, but vary in who actually carries out the casework, and how this is funded. In Australia and the US, there is extensive use of PIPs to provide the last resort function. By comparison, Hong Kong is presently closer to the UK system, in which the ORO body typically carries out the last resort function.

- 1.9 The study did not conclude that one approach was preferable to the other, but simply that alternatives were possible whilst meeting the overall requirement of providing services in all three categories. A number of guiding principles however can be identified:
- a) The last resort function is seen as crucial. However, this can be provided by PIPs rather than government bodies provided that suitable arrangements are in place to compel or persuade PIPs to do so.
 - b) Where PIPs play a greater part there is a stronger emphasis on the regulatory and supervisory role of the ORO body.

2 Liquidation

Issues identified — Caseload

2.1 The volume of liquidations handled by the HKORO under the last resort provisions has increased significantly since 1997.

Liquidation Statistics ²	1996/1997	1997/1998	1998/1999	1999/2000	2000/2001	2001/2002
New cases	557	459	763	895	935	1173
Increase year on year	—	-18%	+66%	+17%	+4%	+25%
Cases on hand at year end	1655	1665	1983	2267	2036	2403
Increase year on year	—	0%	+19%	+14%	-10%	+18%

2.2 This increase is material given the relatively fixed HKORO resources. Civil service regulations and procedures apply to any expansion or reduction of the HKORO's staff numbers and infrastructure. This limits the HKORO's ability to expand or contract quickly to meet variations in case volume. In any event, due to the requirement for prior experience, staff can usually only be recruited at the entry Insolvency Officer level. Any expansion is limited by the need to maintain an appropriate balance of staff experience. Any expansion of resources to meet caseload increases is a more significant and longer-term investment than for a private sector organisation that can rapidly adjust its resources to meet market requirements.

2.3 Moreover, the general trend away from the manufacturing industry, where companies tend to have realisable assets, to service related businesses where realisable assets are less significant increases the possibility of liquidations having insufficient assets to meet the costs of a PIP. This is likely to increase the number of "last resort" cases, at a time when the HKORO is also facing a rapid increase in bankruptcy cases. This places further pressure on the restricted resources available to the HKORO. The increased workload, and in particular the increase in small asset cases, has potential implications for:

- the cost to the public purse of continuing to provide a liquidator of last resort service;
- the effectiveness of the HKORO in handling the liquidation case volume with their existing staffing; and
- the resources available to the HKORO to handle their other service commitments.

² Source: Official Receiver's Office Annual Reports.

- 2.4 These issues have led the HKORO to explore outsourcing to address caseload increases, and in particular the introduction and expansion of the tendering scheme to replace the Panel B system. This is consistent with the government's policy of outsourcing wherever appropriate. Checks and balances can be put in place. In addition to utilising the private sector as a flexible resource to address increases in liquidation case volume, the HKORO considers³ that the outsourcing approach will enable the HKORO to concentrate on other roles, and specifically on regulation and monitoring of the PIPs' conduct of outsourced cases. Conceivably, the HKORO could eventually outsource all case administration responsibility through a combination of the Panel A and tender schemes.

Key Findings

i. Use of outsourcing is appropriate in principle

- 2.5 Any outsourcing system has to address a number of potentially contradictory criteria:
- To ensure the quality of the work is maintained or enhanced by outsourcing;
 - To make cost effective use of public funds; and
 - To maximise private sector participation and ensure fair access to tender opportunities and competition between participating PIPs.
- 2.6 The study determined that the use of outsourcing by the HKORO should:
- Include measures to ensure the satisfactory performance of the PIPs carrying out such work, consistent with the HKORO's desire to expand its regulatory and supervisory activities;
 - Differentiate between a simple administrative "tidy up" process required in non-contentious summary cases, and those cases necessitating both more extensive commitment of resources and insolvency expertise⁴; and
 - Ensure appropriate investigation and enforcement in cases where this is merited, regardless of whether assets are available to cover such costs⁵.

³ Source: 1999/2000 Annual Departmental Report Official Receiver's Office.

⁴ Note that the balance of assets at the moment of liquidation does not indicate the absolute size or complexity of the case, or the possibility of concealed assets or antecedent transactions.

⁵ Lack of any evidence to the contrary suggests that the vast majority of summary cases in Hong Kong are relatively straightforward ones in which a minimal amount of administrative work will properly address the public interest in ensuring an orderly tidy up.

- 2.7 The study concluded that the use of the Panel A and tender schemes has proved a cost-effective approach to meeting the HKORO's obligation to provide a liquidator of last resort. It allows the HKORO to deal with the material increases in case volume at a lower cost than that likely to be incurred by expanding in-house resources. It is in line with the overall policy of the HKSARG to outsource public sector work to the private sector. It also provides an adequate means of maximising participation by PIPs with appropriate experience and qualifications.
- 2.8 Outsourcing does however require a conceptual shift from a system where a public body is available to detect and investigate any unusual circumstances, to a PIP based system where work carried out may be restricted by commercial pressure. In practice the PIPs' statutory requirements, and in the case of the tender scheme contractual obligations, provide protection to ensure that casework is properly completed. However, these checks and balances may not be particularly visible to the public and credit providers. Additional steps may be required to prevent any concern that substantial outsourcing of the HKORO's administration of compulsory liquidations may lead to a dilution in quality and thoroughness of work done in summary cases.

ii. Outsourcing does not fully address the cost of the increased case volume

- 2.9 Outsourcing is not a cost saving device in itself, although it can be argued that it is a more flexible and ultimately less expensive option than expanding the HKORO's in-house resources to deal with the case volume. Ideally it should be accompanied by measures that will directly reduce the cost to the public purse of handling summary cases. Adjusting primary legislation to remove the provision of a "last resort" service in Hong Kong would eliminate such costs, but be contrary to the overall aim of providing an insolvency infrastructure comparable with international standards and consistent with Hong Kong's status as an international financial centre. Options for reducing public cost are therefore realistically limited to one or more of the following:
- Accelerating the resolution of summary cases by reducing the amount of work required in the administration of summary cases, provided that measures still provide adequate protection for the interests of the public and creditors;
 - Passing costs unto specific beneficiaries of the service, if these can be satisfactorily identified, rather than the general taxpayer; and
 - Retaining the provision of a last resort service, but passing the responsibility for its delivery without public subsidy to the private sector.

Recommendations

We recommend the continuation of the outsourcing policy under the Panel A and tender schemes pending the results of a formal consultation exercise to explore the feasibility of a “cab rank” system (see below).

- 2.10 The retention of all or the majority of liquidation cases in-house looks impractical and ineffective in dealing with a fluctuating case volume. It could leave the HKORO over-stretched in recessions, and potentially over-resourced during economic upswings. The wholesale retention of cases may fail to reduce caseload to acceptable levels with consequent impact on staff over-stretch, morale and case performance. The comparative cost estimates produced by the HKORO also provide a strong economic argument in favour of outsourcing.
- 2.11 The Panel A and tender schemes are well established, and appear to be accepted by creditors, PIPs and the public. Provided adequate provisions are in place to protect the quality and extent of work done, and we see no reason for adjustments to the status quo other than the issue of public cost. The HKORO has demonstrated that summary cases can be dealt with more cost effectively by the private sector than in house. As such, the issue of cost is better addressed through measures to reduce the amount of work required in summary cases, and a separate debate on whom should bear the cost, than the retention and administration of cases by the HKORO. Passing case resolution responsibilities to the private sector is an accepted practice in comparable jurisdictions such as the US and Australia.

We recommend against outsourcing the entire liquidation caseload, and consider that the HKORO should retain (unless a cab rank system were introduced) a small number of cases for HKORO resolution.

- 2.12 This would maintain key skills useful in other HKORO responsibilities such as supervision of PIPs. It would ensure that HKORO staff retained sufficient understanding of the practicalities of case management to perform an effective and knowledgeable supervision role. It would also allow the HKORO to deal directly with those small asset cases that merit greater care and attention than a typical non-contentious summary case. Only outsourcing summary cases of a purely administrative nature could help address any concerns over the outsourcing of cases on a fixed subsidy basis where additional investigation or enquiry were appropriate. It also maintains a core of case experienced staff that can deal with cases should the economics or practicality of outsourcing change in future.
- 2.13 ORO bodies in the US and Australia do not conduct cases in house, but in both jurisdictions cab rank provisions exist to ensure that all cases are dealt with. Both organisations also have direct powers of supervision and regulation over PIPs to enforce the conduct of cases. Hong Kong's current insolvency legislation is far closer to the UK, where the OR usually retains responsibility for the administration of summary cases. The outsourcing of the majority of summary cases, particularly those where the liquidation is a largely administrative process, but the retention of a core of cases including those requiring significant non-remunerative work appears to be a reasonable compromise between the two systems. Whilst the wholesale retention of cases seems inappropriate, the benefit of retaining a small and controlled proportion of cases deserves consideration.

We recommend that the HKORO review the allocation of staff and resources to address the change in priorities for case administration consequent on outsourcing the majority of cases.

2.14 PIP compliance with reporting obligations and case resolution are critical to the perceived success of the outsourcing scheme, and controlling the prompt but appropriate payment of PIPs under the tender subsidy is likely to take up increasing amounts of HKORO time and resources. The Scottish ORO body instituted a similar outsourcing arrangement in the 1980's. In that case, the combination of a rapid increase in case volume and lack of resources to deal with the administration of PIPs resulted in considerable delays both in auditing of PIPs accounts and payments to PIPs, undermining the public credibility of the system. Reallocation of staff from the direct case administration of liquidation cases to the supervision and monitoring of PIPs should be considered, and where necessary staff retraining provided.

We recommend that the HKORO utilise this public consultation exercise to explore reductions in mandatory casework for summary cases.

2.15 The provisions of s.227F of the CO already allow for summary case procedures, reducing the workload in such cases by eliminating the requirement for initial creditors' meetings and the appointment of a committee of inspection. The section also provides for "*such other modifications as may be prescribed with a view to saving expense and simplifying procedure*". In this respect, we would recommend a thorough review be undertaken to identify further modifications where existing statutory or procedural requirements are unlikely to be cost effective in protecting the public interest, or add value to the administration of the case. Without restricting the scope of such an exercise, which should be comprehensive, to promote public debate we have identified the following areas as of possible interest:

- 1) ***s.190 Preparation of a Statement of Affairs.*** Whilst this is an obligation on the directors and officers rather than the liquidator, in practice this often requires extensive efforts by the liquidator to ensure the directors compliance. Legislation and the guidelines applied by the HKORO in a summary case could be changed to limit the liquidator's responsibilities in this regard to a clearly understood level. For example, a number of attempts to contact the directors at their last known address. Failure to comply by the directors would still be a matter for enforcement and prosecution, but no further action by the liquidator would be required.
- 2) ***s.191 Report by OR or liquidator.*** The practical ability of the liquidator to discharge this responsibility in the absence of proper books and records and the co-operation of the directors is limited. Provisions allowing the liquidator simply to report the absence of sufficient records or co-operation to allow the completion of the report, and subsequent enforcement or prosecution action by the HKORO could be considered.

- 3) *s.227F Summary procedure order.* This has to be issued by the court. Allowing the OR to determine whether the summary case procedure should apply, with creditors and interested parties having a right of appeal to the court, would avoid the requirement for a largely administrative petition to be filed, minimising cost and use of court time. Similarly, allowing the OR to sanction the destruction of the books and records of the company rather than the court under s.283 would avoid an additional petition process.
- 4) *s. 203 Filing and supervision of accounts.* It seems inappropriate to apply the same reporting and review standard to cases where the assets are unlikely to meet the liquidator's fees. In such circumstances protection against misappropriation or misapplication of assets by the liquidator serves no purpose. It consumes the time and effort of the liquidator in preparation (and consequently increases the cost of the administration) and the OR in reviewing and potentially auditing them. In summary cases this obligation could be revised to allow a single set of accounts at the completion of the case or the end of each year.

2.16 A reduction in the work required in summary cases is consistent with international practice and Hong Kong precedent. Further reducing the statutory obligations in summary cases would reduce the work burden on the HKORO and PIPs, enabling faster close out of cases and an overall reduction in active cases. Reducing the work burden on PIPs accepting such cases under the tender scheme should also result in lower bid prices, contributing to the reduction of public cost.

2.17 The streamlining of statutory procedures in small asset cases is a sensible response to the wide variety in case circumstances. It also reflects market principles (where creditors desire a greater level of work, they can appoint their own PIP at their own cost).

We recommend that the HKORO utilise this public consultation exercise to explore the feasibility of introducing a “cab rank” system.

2.18 In the US and Australia, PIPs are responsible for all compulsory liquidations. Under such so-called “cab rank” systems any PIP who wishes to handle compulsory liquidations must register on a court roll. They are then obliged to take whatever cases the court allocates to them, regardless of the assets available in the case, and without public subsidy. Where creditors do not express a preference, cases are awarded to PIPs on the roll in strict rotation. The liquidator of last resort function is carried out by PIPs on the court roll, rather than a government body such as an ORO.

2.19 At first sight such a scheme looks highly attractive to Hong Kong. This could enable the HKORO to pass all responsibility for liquidations directly to PIPs without the necessity to provide public funding. It would support the HKORO's stated desire to move towards regulation and supervision, and away from casework. However, to be successful such a scheme would require the willing participation of PIPs. To be attractive to the private sector, a reasonable mix of summary and large asset work is required, or sufficient alternative insolvency work has to be available to finance the infrastructure costs of running an insolvency practice.

- 2.20 There is also the possibility of a secondary PIP market developing, as in the US, in which participating PIPs gear their staff skills and infrastructure entirely to summary cases. To a certain extent this commercial imperative is already recognised in Hong Kong, with the differing pre-qualification requirements set for Panel A and tender work. However, this raises the potential for a rota scheme reducing the overall capacity and quality of PIP services available in Hong Kong.
- 2.21 Unlike both Australia and the US, Hong Kong has not historically had a significant volume of large cases under other forms of insolvency proceeding, such as administration or receivership that require and reward the skills and experience of highly qualified PIPs. Moreover, large liquidations in which assets and fees available materially exceed the HK\$200,000 threshold are not common. Over 80% of compulsory liquidations in Hong Kong are summary cases, and the majority of those have less than HK\$50,000 in assets. It is debatable whether a sufficient mix would be available to persuade most current PIPs to participate in a rota scheme in the absence of a subsidy. The use of the Panel A cases to cross subsidise the administration of summary cases may lead to a reduction in the commitment of the major accounting firms and insolvency specialists, who currently dominate the Panel A market, to compulsory liquidations specifically and potentially insolvency in general. This would leave the difficulty of then administering the larger and more complex liquidation cases where the PIP market was predominantly geared towards summary cases.
- 2.22 Paradoxically, such a situation may also discriminate against the smaller players in the market. In practice the larger firms may be better placed to finance the intervals between remunerative appointments. Furthermore, the larger firms may be able to obtain a greater proportion of the larger asset cases by creditor nomination. The assumed balance between larger asset and summary cases may not be available to all PIPs. As a consequence, smaller firms may be less able to compete in such a market than under the current tender and Panel A schemes. In either case the end result may be to reduce PIP participation and skills, rather than enhance participation. It is unclear what impact the introduction of a cab rank system would have on the PIP marketplace in Hong Kong.
- 2.23 The combination of the Panel A and tender schemes has proven very successful at reducing the HKORO caseload, and providing a guarantee of a liquidator acting in every case. Changing the current approach may threaten that success. Such an impact is entirely hypothetical, but the “all or nothing” nature of the cab rank approach makes it difficult to see how such a scheme could be introduced on a trial basis. Whilst the Australian model offers an example of a successful implementation in the region, the differing nature of the market may make reliance on such a comparison misleading.

- 2.24 The introduction of a cab rank system without detailed analysis and review of the potential consequences appears risky and potentially counter productive. The possible benefit in terms of the reduced public cost of providing a last resort function has to be weighed against the potential for a major and potentially damaging change in the quality, capacity and capability of the PIP market. Those PIPs currently willing to carry out summary cases allocated under the tender scheme may not be willing to do so without the tender schemes subsidy, and the requirement to take on such cases may deter PIPs from participating in compulsory liquidations generally. Rather than supporting the HKORO's policy of reducing liquidation casework carried out in house, there is the potential for an increase in cases not taken on by PIPs.
- 2.25 We therefore suggest that the public consultation round for this paper be used to directly address this issue, and further assess the feasibility of its introduction. As the main concern is the possible impact on PIP participation, consultation directly with PIPs and PIP representative bodies would be appropriate.

3 Bankruptcy

Issues identified — Caseload

3.1 As with liquidation, the study found that the major issue affecting the HKORO is caseload. Increases in bankruptcy caseload are even more pronounced than for compulsory liquidation.

Bankruptcy Statistics ⁶	1996/1997	1997/1998	1998/1999 ⁽¹⁾	1999/2000	2000/2001	2001/2002
New cases	562	643	1,179	3,726	4,928	11,764
Increase year on year	—	14%	83%	216%	32%	139%
New cases involving						
consumer credit	13%	15%	47%	68%	71%	79% ⁽²⁾
Consumer "fault" ⁷ cases	15%	14%	41%	40%	33%	30% ⁽²⁾
Debtor Petitions	4%	5%	55%	70%	71%	88%
Active cases at year end	1,286	1,346	2,034	4,648	6,401	13,169

Note: ⁽¹⁾ The 1996 modifications to the Bankruptcy Ordinance providing for automatic discharge came into effect on 1 April 1998, the start of the 1998/1999 reporting year.

⁽²⁾ Provisional figures.

3.2 The extent of the increase is worrying. As well as the increase in fresh cases, the active case volume requiring ongoing administration is also expanding. The majority of bankruptcies involve minimal realisable assets, and allow the application of summary administration procedures. However, the basic statutory requirements applied in all cases impose an unavoidable administrative burden on the HKORO. With largely fixed staffing resources, the time required to process such cases constitutes a significant burden on the existing infrastructure. The HKORO's establishment is geared for the far lower case volume experienced prior to 1998.

3.3 The BO does not contain provisions similar to those introduced to the CO that allow the HKORO to pass over its responsibilities as Trustee to a selected PIP. As such, there has been no experimentation with outsourcing the handling of bankruptcies, whose case burden falls entirely on the HKORO⁸. This places considerable pressure on the resources available to the HKORO to address its other statutory and functional responsibilities. It also practically limits the extent of investigation of the debtor's assets and conduct that can be taken in each bankruptcy case. This said, creditors have a role to play in that they can advise the HKORO as to the need for further investigation.

⁶ Source: Official Receiver's Office Annual Reports.

⁷ For this purpose defined as where investigation into the cause of bankruptcy indicates that the primary reason is the excessive use of credit, overspending, gambling and speculation (excluding cases where cause unknown).

⁸ Arguably the Special Manager provisions could be used, but this would not release the ORO from their statutory responsibilities.

Key Findings

i. Fundamental changes to the bankruptcy system are required

- 3.4 The current legislative arrangements place the responsibility for dealing with bankruptcy almost entirely on the HKORO. The concern must be that caseload levels may rise to the point where the basic social protection elements of formal bankruptcy are threatened. If the HKORO caseload exceeds the resources available to deal with it, the risk is that the investigation of the bankrupts' assets and liabilities, and the proper monitoring of their conduct and earnings during the period of their bankruptcy, will suffer as a result. If that is the case not only is society not receiving its part of the automatic discharge bargain, but there is a risk that the system will be deliberately exploited. This would lead to further increases in petitions and caseload levels, rapidly accelerating the direct public cost of bankruptcy and undermining the system of personal credit.
- 3.5 Some parties interviewed during the study believed that the introduction of automatic discharge and a change in social attitudes towards bankruptcy had removed the deterrent of bankruptcy. Others held that the revisions have simply led to a more open recognition and treatment of an existing volume of personal insolvency that previously never resulted in formal bankruptcy. It is also possible that the rise simply reflects an increased ease in obtaining credit, with a corresponding rise in individuals both deliberately exploiting credit and overspending. In any event, it should be noted that the rapid increase in consumer bankruptcies noted in Hong Kong is a worldwide phenomenon, experienced in a number of jurisdictions irrespective of their underlying bankruptcy provisions. Simply reversing the prior introduction of discharge arrangements, which were consistent with developments in international practice, does not seem an appropriate, effective or sufficient response.
- 3.6 Alternative forms of personal bankruptcy are unlikely to provide a solution under current arrangements. Individual Voluntary Arrangements ("IVAs") are available in Hong Kong, but are rarely used. An IVA has to demonstrate that it can address the costs of its administration, which is unlikely to apply to the vast majority of consumer bankruptcy cases. An IVA is better suited to the low number of cases involving higher income individuals who could potentially make a contribution to their estates over the period of the IVA.
- 3.7 Reducing the volume of bankruptcies by making access to bankruptcy harder and more expensive may reduce the case load followed by the HKORO, but would not be consistent with international trends in insolvency practice. It is generally accepted that society should recognise and address problems with debt. "Hidden" insolvencies distort the relative recovery between creditors dependent on the timing of creditor action and individual leverage⁹. By preventing a recognition and acceptance of the debtor's inability to pay off existing debt, it arguably discourages open disclosure and co-operation by the debtor and encourages further expansion of debt. Bankruptcy provides for an orderly and independent handling of a debtor's estate, equal treatment between unsecured creditors, and allows for the rehabilitation of co-operative individuals. It also allows for the investigation of the bankrupt's conduct in appropriate cases.

⁹ A number of parties interviewed alluded to the activities of debt collection agencies as being one of the prime motivators for debtors' applications for bankruptcy protection.

3.8 Simply accepting the current trend is likely to overstretch the capacity of the HKORO, with potentially serious consequences for the effectiveness and credibility of the bankruptcy process. The existing alternative to formal bankruptcy, IVA, is unlikely to provide a solution, and simply making bankruptcy less accessible does not address the underlying need to deal effectively with large numbers of small asset, personal insolvencies. What is required is a package of measures that will:

- Rapidly increase the resources that can be used to deal with the current case volume, and remain flexible enough to deal with future fluctuations if the current levels are not sustained;
- Enable faster and more cost effective resolution of cases; and
- Ensure that the deterrent and social protection aspects of bankruptcy are maintained.

ii. Outsourcing offers potential for dealing with caseload problem

3.9 Outsourcing bankruptcy would offer some advantages

- Based on the results of the tendering scheme used for liquidations, it would allow a more rapid, flexible and cheaper deployment of additional insolvency resource than expansion of the HKORO's own staff. This would allow the rapid rise in bankruptcy case volume to be addressed, maintaining case management performance levels, but without expanding the HKORO to an inappropriate staffing level if the volume of bankruptcies subsequently declines.
- It could encourage wider participation in insolvency services by the private sector, promoting competition.

3.10 The cost effectiveness of outsourcing would have to be assessed. The benefits of a reduced HKORO workload might be offset by an increased requirement to supervise and administer any contracting out scheme. It may be that the resources saved may simply be absorbed by other tasks. The true benefit would come from increased speed and efficiency of the bankruptcy process, whilst avoiding the slower, potentially more expensive (and of course recurrent) cost of an expansion of the HKORO.

3.11 The extension of outsourcing to bankruptcy appears a logical step given the volume of cases faced by the HKORO, and their prior experience with outsourcing corporate cases. As the statutory processes and procedures are arguably more simple and uniform than liquidations it should be easier to outsource such cases. Any further amendments to provide a "fast track" system (see below) would simplify the process further and reduce the PIP cost. It would also be entirely consistent with the general policy of outsourcing work to the private sector where feasible and appropriate. However, there are limitations to outsourcing such cases under existing legislation.

3.12 At present the BO does not contain provisions similar to those introduced to the CO to allow the HKORO to pass over its “last resort” responsibilities to a selected PIP. Whilst it may be technically possible¹⁰, the procedures are cumbersome. Modifications to the existing legislation would be required to fully exploit the potential for outsourcing.

iii. A “fast track” option would be a cost effective approach to consumer bankruptcy cases

3.13 Consumer credit bankruptcies usually involve a limited value in assets, which are rarely sufficient to meet the costs of the bankruptcy. It is generally recognised that making insolvency available to such debtors, who are never going to be able to pay their debts, meets a wider public interest. However, in the majority of cases, no additional purpose is served by lengthy or extensive bankruptcy procedures. The costs will exceed the assets available, and have to be borne by a third party (typically the public purse). A common response is to reduce the amount of work and expense required in such cases, providing a so-called fast track or administrative approach.

3.14 The BO already goes some way in this direction with the summary administration provisions. However, the trustee remains responsible for the administration of the case until the discharge period expires (4 to 5 years in Hong Kong). This remains the same for both summary and non-summary cases. Even if the OR is not the appointed trustee, he retains obligations in relation to the initial petition and processing of the case, as well as the same general duty to investigate the bankrupt's affairs as applies in non-summary cases.

3.15 In other jurisdictions the modifications are more extensive. In these cases the emphasis is on a largely self-certified process¹¹. This typically consists of the debtor simply submitting a sworn declaration of their assets and liabilities. In the absence of any explicit indications of wrongdoing or creditor complaints the usual obligation on the trustee to investigate the debtor's affairs is absent, and the administration of the estate is cut to a minimum. The discharge period is often accelerated to limit the period that the trustee has to remain in office, consequently cutting cost.

¹⁰ In theory the statutory requirement for the ORO to act as trustee in cases with less than HK\$200,000 could be avoided. The ORO could decline to notify the court under s.112A of the BO, or the court could exercise its discretion and not issue a summary administration order. The ORO could then invite creditors to elect a trustee of their own choice at their cost, or pick one from a list of PIPs with whom the ORO had pre-existing contractual arrangements. The contract would cover the PIPs fees and duties, and as a direct contract would not be subject to the control of the committee of inspection. However, the PIP would be exposed to a wider range of statutory obligations than under a summary administration. As such their required subsidy may be considerably greater than if the legislation was amended to allow the OR to pass on his responsibilities under s.112A of the BO to a nominated PIP. Given the current level of bankruptcies such a procedure could only be practical in a small and carefully selected number of cases.

¹¹ Whilst the US is the primary example of fast track procedures, with discharges commonly taking less than 6 months, it is notable that UK has measures that largely reduce bankruptcy to self-certification, and legislative consideration is being given to early (12 months) discharge in no fault bankruptcies. The UK is even exploring a telephone interview system for consumer bankruptcies. Australia also offers discharge after 6 months in certain cases.

- 3.16 Extension of Hong Kong's summary administration provisions to allow a fast track approach, combining reduced casework with an accelerated discharge period, would offer the HKORO some relief from the expanding number of consumer credit related cases. Arguably this would enable the HKORO to focus its resources on cases with material assets, those where a business is involved and cases in which creditors have expressed concerns over the bankrupt's behaviour. The existing summary administration provisions already anticipate significant reductions in estate management duties¹², so the major change to the spirit and intention of the existing ordinance would be in the treatment of investigation and discharge.
- 3.17 A self-certification approach to bankruptcies that fall within certain criteria could reduce demands on the HKORO and court time without significantly damaging creditors or the public's interest. Additional protection could be built in by requiring more comprehensive investigation where there were grounds to justify it. This would move the position away from a presumption of equal investigation of all cases, to one of limited investigation in summary cases unless there were specific grounds or creditors concern. Provided that there was sufficient protection in place to ensure that a thorough investigation took place in cases meriting it, there should be little harm done to the public or creditors interests, or the deterrent posed.
- 3.18 The reduction of the discharge period may be contentious even though the standard discharge periods in Hong Kong are already above the international norm in comparable jurisdictions¹³. However, in bankruptcy theory the period prior to discharge is intended to obtain further assets for the creditors, whilst providing protection for creditors by limiting the bankrupt's ability to obtain further credit. An accelerated discharge for consumer bankrupts recognises the limited benefit of an extended bankruptcy period where no additional assets are likely. The social protection normally provided by an extended bankruptcy is met through increased penalties for false declaration of assets, and improved public information on prior bankruptcies. This allows the market to decide the risk of extending credit to the debtor in much the same way as requiring an undischarged bankrupt to notify potential lenders of his status.
- 3.19 The sensitivity of this issue in Hong Kong, particularly given the rising number of bankruptcy cases, is appreciated. However, where additional assets or income are unlikely to be added, it is not clear what additional benefit is served by the duration of the bankruptcy that cannot be provided by a combination of public disclosure and limitations on the debtors access to fast track bankruptcy in future. These could be reinforced by a tougher penalty regime for reckless or deliberate abuse of credit after a fast track discharge.

¹² S.112A (1)(b)(iii) of the BO provides for "such other modifications as may be prescribed with a view to saving expense and simplifying procedure, but nothing in this section shall permit the modification of the provisions relating to the examination or discharge of the bankrupt"

¹³ 3 years in the UK (potentially changing to 12 months for no fault cases) and Australia, and typically less than 6 months in the US. Australia also offers a 6-month discharge for selected cases. In Hong Kong the debtor may petition for an early discharge at any time if not previously bankrupt, and otherwise after 3 years.

3.20 Provided that access to the fast track system was restricted to co-operative debtors, first time bankrupts and those not recklessly using credit, there would be no philosophical difference between early discharge under fast track and the current petition system. It would reduce case duration and public cost. It would complement the introduction of an outsourcing approach, reducing the costs of conducting fast track cases irrespective of whether these were handled by the HKORO or PIPs. At present it would appear that an extended discharge period for such bankrupts meets more of a punitive than practical purpose, but at a consequent cost to the public purse that may exceed its practical benefits.

iv. The suitability of an extra judicial process should be debated

3.21 Dealing with consumer debt has been reviewed by one of the main bodies in insolvency practice, the International Federation of Insolvency Practitioners (commonly known as INSOL)¹⁴. They made a number of recommendations, including:

- Legislators should consider providing for separate or alternative proceedings for consumer debtors and small businesses; and
- Legislators should encourage extra judicial or out of court proceedings for solving consumer and small business debt problems.

The first recommendation would be consistent with the fast track procedures discussed above, but it is also worth considering the potential for extra judicial proceedings.

3.22 A distinction should be drawn between fast track procedures and an extra judicial process. Fast track procedures are generally aimed at speeding up case resolution by reducing the duration of bankruptcy and extent of casework in appropriate cases. Whilst fast track procedures may also reduce the number of court petitions, the court retains a central role. An extra judicial process is one in which the court plays a limited role, if at all. However, as a safety net, such systems usually allow for aggrieved parties to appeal to the court for the case to be converted to a normal, court supervised bankruptcy.

3.23 Under an extra judicial system the bankruptcy law defines an alternative to formal, court supervised bankruptcy. This typically provides the debtor with protection against his creditors, requires the debtor to co-operate and surrender assets to his creditors, and imposes penalties for failure to comply. However, rather than being supervised by the court, an independent third party supervises the case under authority delegated by the bankruptcy law. An extra judicial process is usually considered to be cheaper and faster than formal bankruptcy as it avoids court involvement, limits the amount of work required from the supervising agency, and is usually completed far faster than a formal bankruptcy. An extra judicial process:

- maximises the cost and time savings from reducing court petitions and appearances in court;

¹⁴ Consumer Debt Report, INSOL International, May 2001

- avoids any backlogs or delays in process due to limits on court time and resources; and
- can be perceived as less intimidating by debtors, encouraging the appropriate use of a formalised, orderly and independently supervised bankruptcy process by individuals who may otherwise fail to apply for bankruptcy.

3.24 It is debatable to what extent the court can actively involve itself in the majority of the current volume of cases given limitations on its own resources. For that matter, the necessity for court involvement given the nature of the majority of the cases seems questionable. An extra judicial process may be a pragmatic method for accelerating proceedings without detracting from the checks and balances ultimately available to creditors and the public.

3.25 Under such an approach, the BO could provide for an application for an extra judicial bankruptcy. This would be supervised by the HKORO under different regulations to a normal, court supervised bankruptcy. No petition to court would be required, and a debtor could obtain such bankruptcy protection by direct application to the HKORO. The legislation could be drafted to provide penalties for misleading or false applications. The HKORO could retain the discretion to convert the procedure to a full bankruptcy at any point if it was not satisfied that it met the relevant criteria, or was contrary to the interests of the creditors. Similar protection could be built in to allow creditors to petition the court for a conversion to a full bankruptcy if they could demonstrate it was unfairly prejudicial to their interests.

v. *Access to fast track bankruptcy should be restricted*

3.26 If the principles of fast track bankruptcy are accepted, what bankruptcy cases should be eligible for fast track treatment? Any fast track system represents a compromise between the desire to provide an effective solution to the bankruptcy case volume, and the need to preserve the rigor of the existing bankruptcy system. As such, qualification for such preferential treatment is a matter for policy rather than best practice. Access to fast track needs to meet the particular social, cultural and economic requirements specific to each jurisdiction. However, to promote discussion of the topic we would suggest the following categories for consideration during the public consultation:

- The option is limited to individual consumer debtors, excluding trading bankruptcies;

- It is restricted to debtors with small estates that do not merit extended investigation or administration. The best means of achieving this is to place a financial limit on the value of both the assets and liabilities involved. We would suggest as a starting point for discussion limits of HK\$50,000 for realisable assets (net of creditors collateral) and HK\$200,000 of unsecured creditors, broadly equivalent to the average GDP per capita in Hong Kong¹⁵. Providing fast track to those whose unsecured creditors significantly exceeded the average annual income seems unlikely to attract public support as it may indicate a reckless use of credit meriting more detailed enquiry. Realisable assets over the proposed limit should be sufficient to fund a full case.
- Individuals with high incomes are excluded, to allow the use of income payment orders to be considered by the trustee. The limit has to be set at a limit where a payments order is practical, however. Again, as a starting point for discussion we would suggest a maximum annual income of HK\$400,000, or roughly twice average annual income¹⁶.
- The option is only available to “no fault” bankruptcies i.e. those debtors who have not either consciously or recklessly exploited their creditors’ provision of credit¹⁷. A variety of criteria could be applied, but the following seem consistent with the Hong Kong environment:
 - Exclusion of debtors where debt has been recklessly or deliberately incurred e.g. use of credit card credit on multiple cards clearly in excess of any ability to repay (a set multiple of annual income, for example), gambling, speculation, etc.
 - A limit on frequency of application. We note that in the US only one Chapter 7 application is allowed every 6 years, and in England and Wales no summary administration is allowed for a debtor bankrupt in the past 5 years. We would suggest a shut out period equivalent to the the discharge period in a standard case i.e. 4 years, or 5 years after a second case.
- The exclusion of individuals whose bankruptcy arises from a personal guarantee over a limited liability business. This would be consistent with the exclusion of trading bankruptcies and would allow a proper investigation of their conduct and affairs to proceed in parallel with any insolvency of the business, and emphasises the significance and seriousness of such guarantees as a means of collateral.

¹⁵ By way of international comparison we note that the summary administration provision for bankrupts in Scotland, a broadly similar concept, limit application to cases with assets net of collateral of less than £2,000, and with creditors less than £20,000. The summary process in England and Wales is limited to cases with debts of less than £2,000. A review by HKORO of a sample of recent bankruptcies indicated that approximately 17% had liabilities of less than HK\$200,000, and 58% with liabilities less than HK\$400,000.

¹⁶ It is notable that the US Congress is currently debating prohibiting the availability of Chapter 7 bankruptcy to individual debtors with incomes in excess of US\$125,000. This seems very high in relation to typical incomes in Hong Kong, and contrasts with the relatively low threshold for income contributions in Australia (AUS\$35,000).

¹⁷ For example, guarantors for a friend’s or relatives’ debts, or inability to meet existing credit obligations due to illness, disability or unanticipated unemployment

vi. Access to and utility of bankruptcy data should be enhanced

- 3.27 One of the public benefits provided by bankruptcy is the additional protection it offers the providers of credit. It limits the bankrupt's ability to obtain further credit during his bankruptcy without warning the lender of his status (presumably resulting in the rejection of a credit application). The same benefit can be obtained without the requirement for an ongoing bankruptcy, providing that there is ready access to data concerning the bankruptcy. Such an approach is consistent with a free market system, allowing the providers of credit to make their own decisions regarding the provision and pricing of credit.
- 3.28 The current search system operated by the HKORO will disclose a prior bankruptcy, whilst also showing the date of discharge. The details of the original bankruptcy are retained indefinitely on the system. Anyone conducting a search on an individual will uncover details of prior bankruptcies, even after the date of discharge.
- 3.29 The Code of Practice on Consumer Credit Data issued by the Privacy Commissioner requires that details of bankruptcies and schemes of arrangement should routinely be purged from credit data bases 5 years after discharge of the bankruptcy or date of arrangement.
- 3.30 At present, there would seem to be no practical barriers to credit providers obtaining notification of a debtor's prior bankruptcy. The additional protection that deferring discharge offers is therefore limited. Even if the provisions suggested by the Privacy Commissioner are extended to the HKORO search system, credit providers will still be able to obtain details of a prior bankruptcy for up to 5 years after discharge. Any shortening of the bankruptcy period, for example through an IVA or a fast track bankruptcy period with an early discharge for consumer debtors, still gives credit providers a 5 year warning period post discharge. It will not restrict the period of credit protection below that currently anticipated by the 4 to 5 year discharge period in non-repeat bankruptcies.

Recommendations

We recommend that legislative changes be introduced to allow the HKORO to outsource the administration of personal bankruptcy cases

- 3.31 We understand that the HKORO has already initiated a feasibility study to examine the potential for outsourcing. We would recommend that this public consultation exercise is used to support that process by assessing PIPs' interest in such an approach, and provide a public forum to debate support for the legislative changes necessary.

We recommend that a “fast track” bankruptcy procedure be created to deal with selected consumer bankruptcy cases

- 3.32 In our opinion in the majority of consumer bankruptcies little practical advantage is gained by an extended period of administration, or by applying the same level of procedures to all bankruptcies, regardless of scale or complexity. At the same time there is a significant public cost in doing so. A fast track procedure would simply follow the precedent established by the existing summary case procedures to provide a faster and more cost effective resolution of the enormous expansion in consumer bankruptcies.
- 3.33 Such an approach is not inconsistent with maintaining the deterrent of bankruptcy or protecting the public interest, provided such reforms are accompanied by a combination of enhancements to public access to information and an enforcement program independent of the administration of a case. It also recognises that the responsibility of the HKORO is simply to ensure the prompt and efficient resolution of “last resort” cases, and to enforce breaches of bankruptcy law. Part of the solution to current levels of bankruptcy has to lie with appropriate behaviour by lenders and users of credit. To that extent improvements in access to data on bankrupts should prove far more productive, both in protecting lenders and in increasing the deterrent of bankruptcy, than a statutory requirement to administer small asset cases at public expense for extended periods to no direct advantage to either creditors or bankrupts.
- 3.34 Access to such a fast track program should be limited to ensure the balance between effectiveness and deterrent is maintained, and that the program receives public support. Suggested criteria are outlined in paragraph 3.26 above for further discussion during the public consultation.

We recommend consideration be given to making bankruptcy an extra judicial process

- 3.35 The use of an extra judicial process is not currently contemplated by the HKORO, which is instead examining the potential for reducing the number and complexity of petitions to court within the current bankruptcy procedure. It would also require major changes to current Hong Kong law to implement. However, such systems are currently the subject of debate in insolvency circles given the large rises in consumer debt based bankruptcies worldwide. Implementation of such a system would place Hong Kong at the forefront of leading practice in bankruptcy law. Given the proportion of consumer debt cases in the current increase in Hong Kong bankruptcies, it is worth debating in the public consultation whether there is merit in exploring the concept further.

We recommend that public and lender access to bankruptcy data be enhanced

3.36 Access to bankruptcy data should be enhanced.

- Improving the ease of access to bankruptcy data held by the HKORO, rather than requiring individual searches to be made. This is a cumbersome mechanism for providers of consumer credit, who usually deal with a high volume of credit transactions. On-line access or providing specified data on a population rather than a specific debtor basis, would assist such entities in their lending decisions, who could be charged for such a service.
- The HKORO should review the provision of bankruptcy and discharge dates in consultation with the Privacy Commissioner. A set period should be agreed beyond which all details of the prior bankruptcy would be deleted from the public record (although retained by the HKORO for reference in the event of future insolvency). We would suggest a distinction be drawn between an IVA, where the debtor has made efforts to repay his creditors, and the abandonment of debts in a bankruptcy. A longer period of credit data retention in a bankruptcy may help encourage the use of IVAs. Conversely, those debtors whose discharge is deferred should have their data available for a longer period. We would therefore recommend that the HKORO delete from the public record all details of a discharged debtor 5 years after the date of discharge, and details of IVAs 5 years from the date of the composition being agreed with creditors.

4 Regulation and Supervision

Issues identified — No formal regulatory system for PIPs

- 4.1 There is no formal “licensing” procedure for PIPs in Hong Kong. This contrasts with the UK, where by statutory requirement all insolvency work has to be carried out by formally licensed practitioners. In the UK self-regulating professional bodies supervise licensing of PIPs. There is a licensing examination system and tight regulation, with a complaints procedure and an independent audit program to ensure the maintenance of casework standards. By contrast, the HKORO can only exercise control over authorisation of Panel participants, and the allocation of cases under the tendering scheme. This does have a significant impact on the PIP profession in Hong Kong due to a combination of the high proportion of insolvency work awarded by the HKORO, and the use of HKORO authorisation by the markets as a quality and standards indicator. However, neither the HKORO nor courts have any authority over the right of PIPs to carry out voluntary liquidations or other insolvency proceedings.
- 4.2 In principle the absence of a formal licensing system limits controls over entry to the profession by suitably qualified personnel. In addition, there is the possibility that without some form of licensing, unqualified or unscrupulous personnel may conduct insolvencies reducing the credibility of the insolvency system. Public concern over these risks in the UK led to the introduction of the UK’s regulatory system. There is of course a considerable difference between the two jurisdictions, with the UK having a far larger insolvency profession, a considerably greater number of insolvency cases, and a past history of abuses by PIPs. In contrast, there is no record of abuses of the system by PIPs in Hong Kong, and the degree of public concern over the issue is therefore questionable.
- 4.3 With no other party currently playing a formal oversight role, there is an open question as to whether a formal regulatory structure is required, and if so whether the HKORO should operate it¹⁸.

Key Findings

i. HKORO responsibility for fee supervision should be limited

- 4.4 There is a general presumption in insolvency that creditors, who usually bear the costs, have the primary role in approving PIP fees¹⁹. However, the court acts as an alternative authority where appropriate. In Hong Kong the court is responsible for the authorization of any Provisional Liquidator’s fees (as these precede the establishment of the creditors’ committee of inspection), in addition to resolution of disputed fees or those cases without a committee of inspection.

¹⁸ It is notable that in no jurisdiction does the ORO body play a direct role in the general licensing of insolvency practitioners, or routinely involve itself in the authorisation of fees charged for other forms of insolvency proceeding.

¹⁹ Where fees are not paid from case assets, this role usually falls to the funder. This would apply equally to a creditor sponsoring a PIP to complete a summary case as it does to public bodies financing PIPs e.g. the operation of the tender scheme in Hong Kong.

- 4.5 The different basis used by the legal and insolvency professions for charging fees has caused the judiciary some difficulty in carrying out this role. Members of the judiciary have acknowledged this issue, noting that a detailed understanding of the practical issues faced by the profession in conducting cases is necessary to properly assess the reasonableness or basis of fees incurred.
- 4.6 There is a wider debate on the remuneration of insolvency services. The scale of PIPs' fees is an issue that has attracted considerable public attention in recent years in a number of jurisdictions, most notably the UK, where a series of high profile incidents resulted in a working party being led by Mr. Justice Ferris into insolvency practitioner remuneration. This is a far wider issue than the remuneration of liquidators in compulsory liquidations alone, touching on PIP remuneration generally.
- 4.7 These factors have led to debate over the extent of responsibility and authority held by the HKORO, given that:
- The court is looking for additional support in its role of final arbiter of fees. Whether the HKORO should become involved in addressing this is an open issue, but such a role may be consistent with a wider mandate to regulate and supervise PIPs.
 - The HKORO already has some responsibilities for fee supervision in compulsory liquidations. Any more systematic response to addressing PIPs' fees generally may overlap with those responsibilities.
- 4.8 In our opinion consideration of this issue has to differentiate between the HKORO's role in:
- the supervision of fees involving public monies;
 - the supervision of fees in compulsory liquidations and bankruptcies, where the HKORO has direct experience; and
 - a wider role involving the fees charged by PIPs generally in all forms of insolvency.
- 4.9 The extension of the HKORO's role to a wider one of general insolvency fee regulation is not recommended. General international practice is to allow the creditors of an insolvent entity, who are effectively paying for the service, to assess the reasonableness and appropriateness of insolvency fees²⁰. Quite apart from this principle, it should be recognised that the HKORO staff lacks familiarity with the conduct of anything other than compulsory liquidations and bankruptcies, and may not be well placed to assess the reasonableness or appropriateness of fees in such cases. Extending the HKORO's involvement to fee regulation in other forms of insolvency would also require wholesale revision of insolvency legislation, and would be completely unprecedented with regard to the benchmark jurisdictions of the UK, US and Australia.

²⁰ We note the need to ensure an adequate level of investigation and enforcement action in cases, and acknowledge that where such action does not lead to increased asset recoveries its costs may not be supported by creditors, contrary to a wider public interest. However, this issue is already addressed in part by the statutory requirements imposed on the PIPs, and the ability of PIPs to appeal unfair fee decisions to court.

4.10 Many insolvency jurisdictions, Hong Kong included, provide for the court to act as a forum for appealing insolvency fees in both court appointed insolvencies and other forms of insolvency proceeding. We consider that the court's role as final arbiter is consistent with the primacy of the courts in the conduct of insolvency, and appropriate. Possible difficulties experienced by the court in assessing reasonableness of fees in such circumstances are appreciated. However, such difficulties do not in themselves provide a mandate for the involvement of the HKORO, particularly given the degree of legislative change this would entail and the current pressure on HKORO resources. In our opinion a more appropriate response to such difficulties would be for the development of agreed principles and guidelines for the court to follow in determining judgements, following the approach taken by the Ferris Committee in the UK²¹.

4.11 Where public funding is used, the HKORO has a direct mandate and responsibility to supervise fees to protect the use of public funds. However, there is already ample provision for this, both in statute and in the contractual arrangements made when committing public funding to the PIPs. As such, we do not believe an extensive revision of the HKORO's role is necessary, but we would note the importance of continuing the HKORO's policy of:

- Expanding resources committed to the area of fee audit and PIP supervision for cases funded by public monies in light of the material increase in outsourced summary cases
- Selecting a random sample of smaller compulsory cases, as well as a sample of the larger Panel A cases, to audit and review in greater detail. Similarly, a selection of bankruptcy cases should also be included if and when any contracting out takes place.

ii. There are practical constraints to the introduction of a formal PIP licensing system similar to those used in other jurisdictions

4.12 The licensing/regulation of PIPs is often a time consuming and costly exercise, and any consideration of the issue has to recognise the size of the insolvency market in Hong Kong. As at September 2001 there were only 52 appointment takers and an additional 32 Insolvency Practitioners across the 15 firms registered for Panel A. The Hong Kong insolvency practitioner pool is a relatively small one, especially if compared with a jurisdiction such as within the UK, where the number of licensed insolvency practitioners exceeds 1100.

²¹ The Ferris Working Party formally examined the issue of liquidators' remuneration. This followed concerns expressed by the judiciary that the courts did not have a formal system for fixing PIPs fees, and that they were being asked to approve some very large amounts in a number of major cases. The Working Party's findings noted the need for PIPs to be able to demonstrate not only how the time spent was built up, but the purpose of the work, and where appropriate, the value added. The UK insolvency profession is in the course of amending its guidelines on fees to reflect the key findings, including provisions for activity based time reporting, disclosure of fee rates and controls on contingency fee arrangements.

- 4.13 Even with a large PIP base to spread the fixed costs of a regulation and supervision structure, the costs of individual PIP regulation can be material. For example, each UK RPB levies additional fees on PIPs in order to recover the costs. The fees charged vary by RPB, but these are typically between £1,000 and £2,000 per licensed individual. With a considerably smaller number of PIPs in Hong Kong, the per capita costs of running such a system would presumably be considerably greater. These may discourage the entry of smaller firms of practitioners into the market. Against these costs, there is no record of past abuses of the system by Hong Kong PIPs.
- 4.14 At the same time, the Law Reform Commission (“LRC”) has rightly pointed out that although most liquidations are carried out in a proper and fair manner, regulating and overseeing the functions of the PIPs will strengthen and reinforce the system. It will also address an apparent gap between Hong Kong and comparable insolvency jurisdictions.
- 4.15 The LRC has proposed a two-tier approach to licensing and regulation. The recommended two tier structure is described in full in the LRC’s 1999 “Report on the Winding-Up Provisions of the Companies Ordinance”, but in essence formalises the approach developed for Panel A and B. PIPs would be required by law to be licensed to practice insolvency. The tier system would be used to provide separate licensing arrangements for less complex forms of insolvency, such as members’ voluntary liquidations (“MVLs”) and IVAs. Both tiers would require the PIP to be a member of a recognised professional body, to allow the disciplinary system of such a body to exert additional control over PIP conduct. Licensing would initially be carried out by the HKORO based on PIP experience, but would transition to an examination system.
- 4.16 As an alternative, we would suggest a single tier, authorisation based system could be used. As with the LRC proposal, there would be a statutory requirement for all PIPs to be authorised to carry out insolvency work, and membership of a professional body would also be a prerequisite. Rather than dividing insolvency into only two levels, however, the authorisation could have specific limits dependent on the firm or individual authorised. For example, a PIP who deals solely with MVLs could be authorised only to deal with such cases. Moreover, such a system would be based on a “fit and proper” test set by the authorising authority, following current practice with Panel A, rather than an examination system.

Recommendations

We recommend that the HKORO should not be responsible for PIP fee authorisation except where it has a direct and appropriate involvement in the specific case concerned

- 4.17 It is a generally accepted insolvency principle that creditors should have the right to determine fees in the first instance, as they are usually funding the fees. There are clear and adequate provisions for the court to act as an arbiter in the event of a disagreement between PIP and creditors. In any event, the HKORO lacks sufficient experience in insolvencies other than compulsory cases to add sufficient value to their intervention to justify the extensive

legislative changes that would be needed to support it. The HKORO already plays a role in the supervision of fees in the majority of compulsory cases through the public subsidy of PIP fees, and their supervision of that system.

We recommend that the consultation exercise should be used to assess the degree of support / desire for a formal licensing system, and whether such a system should involve the HKORO

4.18 The strongest arguments in favour of PIP licensing are comparability to other jurisdictions and general good practice. However, there is no track record in Hong Kong of problems with PIPs, and the insolvency sector is relatively small. If the arguments in favour of some form of wider PIP regulation system are accepted, that does not of necessity imply that the HKORO should fulfil such a role rather than some other body (e.g. professional bodies, as in the UK).

4.19 In our opinion setting up the type of formal licensing regime operated in the UK would add to the burden of work for the HKORO, would include significant and potentially irrecoverable costs, and may limit rather than encourage the development of, and competition in, the insolvency sector. It would also require legislative change to implement. Strong public support for its introduction, and the involvement of the HKORO, should be a prerequisite before initiating the necessary legislative changes and adjustments to the HKORO's stated role, staffing and infrastructure.

If consultation shows strong support for a HKORO administered licensing and supervisory system, we recommend a simple system based on authorisation

4.20 The principal reservation with the LRC scheme is whether the size of the PIP market justifies the additional complexity, cost and supervisory effort of a formal examination based approach. We would recommend a less formal scheme of direct authorisation by the HKORO (or whatever other body is selected). There would be a statutory requirement for PIPs to hold the appropriate authorisation from the HKORO (or other authorisation body). However, the legislation would be silent on the mechanism by which authorisation was granted.

4.21 Authorisation could follow the template established by the Panel A and tender schemes. PIPs would be required to show satisfactory experience and staff resources to handle whatever type of insolvency they wished to be authorised for. No examination would be used, and there would be no formal audit and supervision process. However, the ability to remove or qualify authorisation would make the authorising body a useful forum for any complaints by the public or creditors, without imposing a significant supervisory burden in the absence of such complaints. PIPs would have to co-operate with any investigation by the authorising body without the need to provide it with statutory powers of investigation. To protect the interests of PIPs, however, the statutory requirement to obtain authorisation could be qualified by allowing PIPs to appeal a decision by the authorising body to the court if the PIP could demonstrate that the decision was based on inaccurate information or inconsistent with the authorisation of other PIPs.

5 Enquiry and Enforcement

Issues identified — Adequate enforcement is key to effective insolvency

5.1 The study examined enforcement under three specific sub-functions:

Enquiry — Investigating the circumstances of insolvency to identify possible pre or post insolvency offences, and generally satisfy creditors and the public that assets have not been concealed or that the insolvency was not attributable to reckless or deliberate conduct.

Prosecution — Taking action for the prosecution of insolvency offences.

Prevention — Disqualification of unfit directors, and delaying the discharge of bankrupts, to limit repetition of offences.

5.2 Ensuring the investigation of potential offences and misconduct, and prosecution of offenders, is central to the proper policing of insolvency. It is an essential part of maintaining market discipline, avoiding abuse of the availability of credit and limited liability. Prosecution and prevention activities are routinely seen as the responsibility of the state in most jurisdictions. However, both activities are dependent on adequate enquiry taking place to detect offences.

5.3 Typically this is achieved through a statutory requirement for a liquidator or bankruptcy trustee to carry out a basic level of enquiry into the events leading to insolvency, the assets available to creditors and the conduct of bankrupts or company officers. This is accompanied by a reporting mechanism to ensure that the creditors and interested parties are informed of material issues affecting the assets available in the case, and an obligation to refer matters requiring prosecution or prevention action to the appropriate authority. Variations on such a system are common to the UK, Australia, and US. Problems can arise where there are insufficient assets to meet the time and expenses of providing this level of basic enquiry.

5.4 PIPs are typically paid from the case assets. Where the assets are insufficient to meet the costs of investigation, there is no commercial incentive to pursue matters coming to the PIP's attention that do not demonstrate a realistic prospect of additional asset recoveries. Whilst a PIP does have professional standards to meet as well as statutory obligations to investigate, commercial pressures may lead to the minimum time and resource necessary being spent to discharge the obligation.

5.5 As such, ensuring a minimum standard of enforcement in small asset cases can be the responsibility of state bodies such as the HKORO. This can either be through the state body assuming some or the entire investigatory obligation in small asset cases, as in the UK, or by clearly defining in law the amount of investigatory activity that has to be carried out by PIPs, with the state body regulating the PIPs conduct. As Australia and the US rely on the cab rank system to handle small asset cases, the focus there is more on PIPs carrying out a prescribed amount of enquiry.

- 5.6 Consideration of this topic should note at the outset that any extension of the current levels of enquiry and enforcement activity is likely to result in increased costs. Dependent on who carries out the work and the availability of assets in the cases concerned, such costs may fall upon creditors or the general public (through the costs of financing activity carried out by or financed by the ORO). The possible burden on public funds of an enhanced enforcement regime has to be balanced against the public benefits of such a system. Responsibility for meeting such costs is a valid consideration both in setting the level of such activity, and allocating the responsibility for its discharge.

Key Findings

i. Extent of enquiry function does not meet creditor expectations in small asset cases

- 5.7 The enforcement function is clearly seen as important by interested parties in Hong Kong. All parties interviewed during the course of the study expressed strong support for a vigorous execution of the function by the HKORO. The LRC's report reflected this sentiment, commenting on both the prosecution of offences and the HKORO's role in enforcement. Their views are perhaps best summarised by the following quotes from their report:

*"We state, unreservedly, that there is a vital public interest in having a clean and open insolvency regime with a proper investigatory framework. We consider that the need for enhancing the role of the Official Receiver's Offices as to be capable of fulfilling this role is of great importance for the business community and the society of Hong Kong as a whole"*²², and further

*"the Official Receiver's Office, in the public interest, should take a more positive role in the enforcement of proper investigatory provisions and the establishment of regulatory procedures that would apply to all companies that go into liquidation, whether asset less or otherwise"*²³

- 5.8 There is no evidence to suggest that the HKORO or PIPs are deficient in carrying out statutory enquiries. The HKORO has pointed out that case officers carry out an enquiry into the affairs of every bankrupt, and it has not received a significant volume of creditor complaints over the extent of enquiry by either the HKORO or PIPs. However, our interview round indicated a general perception that insufficient resources and concentration are paid to this aspect by both the HKORO and PIPs.

²² Para 5.13, Report on the Winding-Up Provisions of the Companies Ordinance July 1999

²³ Para 5.1, Report on the Winding-Up Provisions of the Companies Ordinance July 1999

5.9 The reservations openly expressed by the LRC in this regard, and the associated comments from the Hong Kong Association of Banks²⁴, reinforce this view. They suggest that a combination of inadequate resources and commercial pressures may result in a lower level of investigatory effort than is generally desired by the market. The level of prosecutions and disqualifications (commented on below), and the nature of the offences prosecuted, may also reinforce public perceptions of low or superficial levels of investigatory activity by both HKORO and PIPs.

ii. Perception that the level of prosecution is limited

5.10 Our interview round suggested a general perception amongst interviewees that the HKORO does not prosecute as extensively or as effectively as it should. This perception is consistent with the LRC report, which commented on:

“the unsatisfactory level of prosecutions of directors and a need for a general reconsideration of how dishonesty on the part of company directors might be addressed more effectively”.

5.11 It referred specifically to the low level of fines imposed by magistrates for offences, particularly failure to maintain accounts, and the corresponding difficulty in prosecuting other offences in the absence of such accounts. This attitude was fairly consistent amongst interested parties interviewed during the study.

5.12 The study in fact found that the total number of Hong Kong prosecutions was consistent with the UK, where comparable legislation applies. However, it noted a comparatively narrow range of prosecution for liquidations. Nearly all offences prosecuted related to “accounting omission” offences involving the keeping or presentation of data to members, the HKORO and creditors. Despite the wide range of offences covered by s.271 to s.276 of CO, only s.274 was commonly utilised. We consider that it is this narrow range of prosecutions that underlies the general perception of limited action. Not only do the other categories of offence attract higher scales of penalties, but to the general public they more accurately reflect misconduct. The absence of books and records in many cases make the identification and prosecution of offences (other than failure to maintain books and records) difficult. The lack of prosecution of other offences may also reflect a lack of actual offences rather than any omission by the HKORO. The LRC also noted that the prosecution of PIPs’ cases was dependent on PIPs’ reporting of offences, which tended to be limited to the more easily identifiable breaches such as s.190 and s.121/s.274 of the CO.

²⁴ In Paragraph 11.41 of Law Reform Commission report, it was stated that “A submission of the Hong Kong Association of Banks suggested that there was, in appropriate cases, a need to conduct an investigation to expose malpractice with a view to eventual prosecution and that such investigations had to be a matter for the Government whereas private sector liquidators should focus on the realisation and distribution of assets. The submission added that such investigations should not be funded from an insolvent company’s assets on the basis that it had never been accepted that the victim paid for the investigation of crime.”

- 5.13 The levels of prosecution in bankruptcy cases also seemed low. In 2001/02 less than 6 cases in every 1,000 were prosecuted. This level of prosecution appears low given that offences provided by law cover such items as failing to reveal and deliver up property, gambling or failure to keep trading records. Of course, the practical difficulties of investigating and prosecuting what are largely consumer-based bankruptcies should not be underestimated. In such cases there are rarely books of account or adequate records, and the HKORO is heavily reliant on the co-operation of the debtor and complaints by creditors in identifying offences. Complaints by creditors are rare. The level of prosecutions may demonstrate a relatively static volume of serious offences being distorted by the significant increase in consumer related cases.
- 5.14 Regardless of justification or reasonableness, there is a definite perception that the HKORO's prosecution focus does not reflect the public's belief in the pattern of underlying offences, or the desire for overt punishment for offences of commission rather than omission. Moreover, the low level of bankruptcy prosecution, however justifiable, runs a risk of building a perception of bankruptcy as a risk free means of escaping responsibility of reckless or dishonest use of credit.

iii. The effectiveness of prosecution and disqualification is questionable

- 5.15 The level of fines imposed for successful prosecution is out of keeping with the seriousness of the offences, and the cost of enforcement. The 262 convictions obtained in 2001/02 averaged a fine of HK\$1,062. Average fines for breaches of s.274 of the CO were HK\$547 in 1999/2000, HK\$437 in 2000/01 and HK\$574 in 2001/02. The level of penalty achieved has reached the nonsensical position where it is cheaper not to comply with a statutory requirement and pay a court penalty than to incur the costs of complying in the first instance. The level of fines is a matter under the control of the magistrates' courts rather than the HKORO, and the Department of Justice has to approve any HKORO appeals on sentencing. The HKORO has to prosecute in accordance with Department of Justice's guidelines. However, the consequent public criticism of failing to maintain an effective deterrent to offending behaviour tends to be attributed to the HKORO in the absence of clear explanation as to relative responsibilities.
- 5.16 The study also noted concerns on the limited range of grounds on which director disqualification actions were brought. As with prosecution, the vast majority of disqualification actions were based on "accounting omission" offences. All disqualification orders made in 2000/01 and 47 of 48 of the cases pending at year-end fell into that category. This reinforces a market perception that the HKORO has a policy of seeking prosecution on the relatively easy burden of proof offences and using the conviction to underpin a disqualification application on the same grounds. Such perception may be unfair, as the HKORO has to prosecute in accordance with Department of Justice's guidelines. These include criteria relating to prosecution in the public interest and sufficiency of evidence.

- 5.17 The severity of disqualification orders is also of interest. The average disqualification period awarded in 2001/02 was just over 3 years, whereas s.168 of the CO provides for disqualification for up to 15 years. Two awards were made for 6 years and one for 8 years. By comparison, of the 1,540 disqualification awards made in the UK in 1999/2000, 44% were in excess of 6 years, and 37 cases in excess of 10 years. A direct comparison between jurisdictions may be misleading, but the similarities between legislation in both are significant. It is not clear whether the difference in outcome is attributable to a difference in the sentencing criteria being applied by the respective judiciary, the underlying offences committed or the basis for disqualification being raised by the HKORO. In any event, the severity of disqualification orders should be directed by circumstances of cases.
- 5.18 What would appear clear is that the current level of fine and disqualification is unlikely to prove an effective deterrent to rogue directors and bankrupts. Moreover, prosecution of a limited range of offences can undermine the deterrent effectiveness of statutory regulation on other offences, and potentially public confidence in the enforcement role.
- iv. A strong enforcement function is needed to offset concerns over outsourcing HKORO responsibilities and reductions in statutory casework*
- 5.19 Concerns over the adequacy of enquiry and enforcement are likely to increase if other measures recommended in the study are implemented, such as the introduction of fast track procedures for bankruptcy, the reduction of mandatory casework in liquidations, and the increasing use of outsourcing. Other jurisdictions face the same issue. The problem is ensuring that an activity that has public policy benefits, but may not result in asset realisations to cover its costs, is carried out.
- 5.20 In the UK this is largely achieved by the OR retaining an investigatory role even if a PIP is subsequently appointed, eliminating commercial considerations that may apply to a PIP²⁵.
- 5.21 In Australia the statutory requirements for enquiry in corporate cases are supplemented by guidelines on best practice. These require more extensive reporting where there is a significant shortfall to creditors, and make it clear that lack of funds is not a reasonable excuse for failure to do so. Bankruptcies are commonly dealt with by the Official Trustee, but in both state and PIP administered cases the statutory obligations are supplemented by standards of enquiry set by the Personal Insolvency National Standards. These are established by agreement between ITSA and the PIPs' representative body, the Insolvency Practitioners Association of Australia ("IPAA").

²⁵ See Insolvency Act 1986, s.132 and s.289.

- 5.22 The US has a far lesser statutory burden of enquiry. Whilst Chapter 11 proceedings impose a general requirement to investigate and report on the acts and conduct of the debtor, enquiry and reporting obligations under the more comparable Chapter 7 are more limited. These include an obligation to investigate the financial affairs of the debtor and providing an inventory of assets and liabilities. However, in Chapter 7 a public examination of the debtor under oath is available in all cases, thereby allowing creditors to examine the debtor if unhappy as to the extent of the trustee's inquiry²⁶.
- 5.23 In other jurisdictions concerns over the level of enquiry are addressed by retaining that responsibility within a non-profit orientated body, as in the UK, or by providing for additional safeguards. The latter can include non-statutory requirements imposed and regulated by a supervisory body to ensure an adequate level of enquiry where appropriate. Adopting similar measures in Hong Kong may help address current perceptions. It would offer a useful reassurance for creditors concerned that recommended reductions in case work and the transfer of cases to a profit orientated private sector would not undermine the basic enquiry necessary for effective enforcement.

Recommendations

We recommend that the HKORO establish a specialist investigations unit

- 5.24 A specialist unit could be created within the HKORO, dedicated to performing more thorough and comprehensive investigations. Such a unit would deal both with cases retained by the HKORO²⁷ and any cases in which the need for additional enquiry was flagged by the PIP or creditor complaints. Given that the case volume for such a unit may be highly variable, this unit could be established on a cadre basis. The role and functions of the unit could be specified, and key individuals designated to lead any cases arising and handle management functions. However, the bulk of any investigation team could be assigned to the unit from different divisions within the HKORO when the need arises, to maintain flexibility and cost-effectiveness.

We recommend that the minimum level of enquiry should be increased in summary cases

- 5.25 Liquidators could be obliged to reconcile the companies' statement of affairs to the last published accounts, and comment on any apparent irregularities or inconsistencies. In the same vein, similar reporting provisions to s.191 of the CO could be introduced for those bankruptcies with over a de minimis value in creditors. In both cases revisions to primary legislation would be required to compel such provisions in all cases. However, given that in excess of 80% of liquidations are usually compulsory, and virtually all bankruptcies pass through the HKORO, such standards could instead be set as a matter of working practice rather than statutory obligation.

²⁶ Title 11, United States Code, s.704 and s.343.

²⁷ See Section 2 for recommendations on the retention of a small number of liquidation cases by the ORO. This would specifically include any summary cases thought to be contentious and where the necessary investigative effort would clearly exceed the resources available to the PIP under the tender scheme. Under current arrangements virtually all bankruptcies would also have to be retained, given the difficulties in outsourcing these. However, if outsourcing were introduced the retention criteria should be similar to those for liquidations.

- 5.26 Practical and cost effective compliance with such a requirement may prove difficult in the absence of adequate records. However, in that event the liquidator or trustee could simply report that the absence of records (in itself an offence for companies or trading bankruptcies) did not enable them to complete such a requirement, enabling prosecution for failure to maintain adequate records instead.
- 5.27 As an alternative, Hong Kong could follow the practice in Australia, and provide detailed guidance on an appropriate level of enquiry expected both from PIPs and HKORO case officers. This would not have statutory force, but would have a wide-ranging practical impact if incorporated into the tender scheme contractual requirements and the conditions for Panel A membership. If all Panel A and tender scheme members adhered to the code of practice, this could rapidly develop as an industry standard expected by creditors making direct appointments. If such guidelines received the backing of PIPs' associated professional bodies, this would provide a powerful albeit non-statutory means of regulating the level of enquiry work performed.
- 5.28 The introduction of an accounts reconciliation, or alternatively guidance notes²⁸ indicating a suggested level of enquiry by PIPs, would reinforce the emphasis on this area of insolvency. Increasing the emphasis on investigatory activity is consistent with best practice, and above all may help address any perception that the HKORO or PIPs are deficient in this regard.

We recommend that the prosecution and disqualification policy should be modified

- 5.29 The HKORO could increase the resources allocated to the Legal Services Division, including the use of temporary staff and outsourcing if necessary, and introduce an openly aggressive policy on prosecution and disqualification of offenders. This might include:
- Widening the range of offences prosecuted, and increasing the number of cases brought. Multiple charges could also be employed, using the easier burden of proof offences under s.121/s.274 etc to ensure a conviction, whilst still prosecuting other offences committed.
 - Increase the use of appeal of magistrates' court decisions to seek an increase in the level of fine imposed. The vicious circle in fine levels established by precedent may be broken by appealing selected cases to a higher court where a greater tariff is more likely to be imposed.

²⁸ These could be issued by the ORO, or by professional PIP bodies such as HKSA. They would not have statutory force, but may establish a benchmark for best practice. Their effectiveness would be greatly enhanced if introduced as part of any wider revision of PIP regulation and supervision. Compliance could be made a requirement of the tender and Panel A schemes.

We recommend that the HKORO improve communication with the public on enforcement matters

5.30 To be effective as a deterrent, and to satisfy interested parties that the enforcement function is adequately addressed, the HKORO not only has to provide an effective enforcement environment but also communicate that to the public. In that regard we would recommend four areas for action:

i. Improve communication of enforcement action.

5.31 As part of the problem may be public perception rather than fact, the HKORO should consider measures to improve communication of their enforcement activities. The UK ORO includes summaries of selected prosecution and disqualification cases in their public reports. ASIC follows a similar practice, and the US Trustee program publishes a synopsis of selected civil and criminal cases as well. Increased publicity on successful cases in Hong Kong could achieve a similar objective. This provides a deterrent value by emphasising enforcement action. Such a policy also highlights the success of the agency and acts as a means of educating the public on what constitutes an offence, reinforcing parallel schemes to encourage public reporting of offences.

ii. Increase reporting of offences to the HKORO

5.32 The HKORO could institute and publicise an easy means for creditors and the public to report suspected offences for consideration and possible investigation. A public hotline such as that used in the UK and commended by the Director of Audit would be one possible means. In addition, the HKORO could use powers of suasion available to it in its dealings with PIPs to encourage more proactive reporting of possible offences.

iii. Use informal working groups to improve co-ordination of interested parties.

5.33 The HKORO's instigation of an informal Working Group on Consumer Bankruptcy, and the HKORO Services Advisory Committee comprising representatives of lenders, PIPs and consumers, are a welcome development in improving co-ordination. Improved communication assists the detection and effectiveness of enforcement action, and feedback from cases handled may also assist in the modification of regulatory and lending activity to limit the future incidence of offences. Such groups also help address any misunderstanding of the extent of the HKORO's powers and responsibilities. A better understanding of the difficulties faced by the HKORO in enforcement and prosecution may allow lenders to modify lending practices to ensure they are consistent with the requirements of prosecution. A topical example would be adopting lending documentation that required explicit representations by borrowers and provided clear warnings, making it easier to demonstrate intentional offences by the debtor and obtain correspondingly higher penalties.

iv. Improve access to and utility of information.

- 5.34 The other key element is enhancing access to information. Planned improvements to the HKORO's management information system provide the potential for on line access to default data. We would recommend that this be extended to include data on directors of insolvent companies as well as disqualified directors.
- 5.35 We would strongly recommend that data be provided in a way that ensures that this is specifically linked to the individuals concerned. The common use of a number of names in Hong Kong undermines the effectiveness of such data unless a unique identifier is used. In addition, there is a risk of confusion between the individuals concerned and others. Mistakes in identification can lead to completely uninvolved individuals bearing the consequences of others actions.

6 Finance

Issues identified — No agreed basis for cost sharing

6.1 In an ideal world HKORO services would be financed:

- In part by following a “user pays” approach, and imposing compulsory charges or taxes on the user or user group for those services; and
- By funding those services of benefit to the wider community through public funds, in turn financed through general taxation.

6.2 However, three basic problems are encountered with using such an approach to determine the financing of insolvency services:

- defining who the users are, and their ability to pay. For example, who are the beneficiaries of the large volume of consumer bankruptcies currently conducted by the HKORO?
- separating those services of specific benefit to user groups, and therefore eligible for specific charges, from those of a wider benefit and more appropriately funded by public funds.
- defining what constitutes an adequate level of service. There is a trade off between the level of insolvency service provided, and the consequent need to finance the delivery of such a service. Finding an appropriate balance that will satisfy all parties is extremely difficult.

6.3 These problems are common to most jurisdictions. However, the lack of an agreed conceptual basis for allocating charges between users and the general taxpayer means that there is no clear basis for preferring one financing method to another. Any user group facing an increase in charges, including the general taxpayer, can argue that they are absorbing an unreasonable proportion of someone else's cost. Choosing between financing alternatives in such a situation becomes largely a policy choice. As such, debate over HKORO financing is likely to focus on:

- a) determining the level of service provided in the first instance, and
- b) allocating that cost between users and the public based on policy choice rather than conceptually valid cost allocation.

6.4 As such, the study did not make specific recommendations for financing of the HKORO. Instead, it confined itself to identifying the advantages and disadvantage of a number of likely options, leaving the final selection to a policy choice to be influenced by the public consultation process.

Key Findings

i. Current financial performance evaluation system is conceptually flawed

- 6.5 At present the HKORO is expected to recover 60% of its costs, with this proportion being kept under review by the Secretary for the Treasury and the Secretary for Financial Services. In our opinion using a set percentage of cost recovery as a financial performance measure is questionable. The percentage is a well-intentioned attempt to differentiate between those costs that should be provided as a public service and those that should be charged to the user. However, the proportion of chargeable versus public service activities will inevitably vary by year dependent on case mix. These changes will not necessarily be reflected in a revised percentage.
- 6.6 More fundamentally, a straight percentage of total cost recovery does not form a useful measure of performance, as it fails to differentiate between controllable and non-controllable costs and revenues. A performance measure should be based on items that the HKORO has the ability to control through improved performance. As already noted, the HKORO's cost base is largely fixed, its workload prescribed by statutory obligation, and its revenue fluctuates according to the number of insolvencies.
- 6.7 Currently the HKORO tries to address this problem by modifying the computation to exclude revenue from unusually large liquidation cases and expenditure properly borne by the administration e.g. prosecutions, policy development etc. The compromise is based on a well founded desire to base performance on typical revenue streams by eliminating exceptional cases, and by not directly accounting for costs seen as government responsibilities. However, the elimination of specific revenues and costs becomes a matter of judgement, which makes true comparability of performance between periods difficult. Moreover, there is no immediate and direct link between the final ratio and published accounting data. A detailed analysis of the computation is required to fully understand the true performance and the underlying cost and revenue performance.

ii. Fee base is complex

- 6.8 The current variety of fee tariffs for the HKORO increases the complexity of compliance for PIPs and the public, as well as the administrative burden in policing fees.

Proceeding	Number of Fixed Fees	Number of Non-Fixed Fees
Bankruptcy	15	7, incl. 2 sliding scale based
IVAs	0	2
Winding Up	12	10, incl. 2 sliding scale based
Total	27	19

Many of these fee categories earn no material fee volume, with 16 of the 27 fee captions noted earning less than HK\$100,000 each in 2001/02, and 21 less than HK\$1 million. Certain of the fees have a degree of complexity in their calculation which seem unnecessary, and ineffective in influencing overall HKORO revenue or the level of fees in each case. For example, the sliding scale fees on ad valorem fees have 5 separate categories, but these escalate fairly quickly if applied against the larger corporate cases typical of the private sector. A flat rate realisation fee would be far easier to police and apply.

Financing Alternatives Available

6.9 The study considered various funding options already considered by the LRC and Director of Audit's report, and commented on each, as well as the introduction of a cab rank system. Some of these options are philosophically, if not practically incompatible, but they are discussed in parallel to promote public debate. In any event, as a practical matter, it seems likely that any funding mechanism is likely to contain a mixture of approaches, consistent with most insolvency jurisdictions.

6.10 The main financing areas considered to date include:

- Diversion of a proportion of the Business Registration Fees.
- An increase in interest charged in CLA (from 1.5% to say 2%).
- An increase in HKORO fees.
- An increase in petitioners' deposits.
- Direct Government subsidy (reflecting the role the HKORO plays in ensuring the provision of basic insolvency service, and enforcing a well-run insolvency regime).

i. Business Registration fees

6.11 The LRC has suggested using a proportion of the Business Registration fee to finance the HKORO. This suggestion is founded on the argument that the primary beneficiaries of a well-run and orderly insolvency system are companies utilising the system of limited liability and reasonably priced credit that such a system allows. Adopting the "user pays" argument, arguably businesses should finance the safety net that the HKORO provides.

6.12 The first question has to be whether the funding provided to the HKORO comes from an extension to the registration fee, or diversion of existing registration fee revenue. An extension in registration fee is likely to attract business criticism, although arguably the current fee is fairly modest (and whilst there is no direct comparison, considerably less than the HK\$12,150 liquidation petition fee). Diversion of the existing revenue would reduce the funds allocated to the general revenue account²⁹. Deduction from the general revenue's proportion is no different to direct public subsidy. It has the added problem that any ring fencing of a proportion of the fee for the HKORO reduces the government's flexibility in application of the monies raised. It also has the drawback of fluctuations in revenue based on the trade cycle. However, an increase in the fee would place the burden directly on the primary beneficiary of a well-controlled insolvency sector.

6.13 Given the size of the registration fee income stream in relation to the typical HKORO deficit, a modest increase in fee would have a significant impact on HKORO finances. For example, in 1997/98 the HKORO's cash deficit was approximately HK\$20 million, and it had a full costing funding requirement of HK\$105 million. Even a 5% increase in the business registration fee for that year, considerably less than the proportion allocated to the Protection of Wages fund, would have provided approximately HK\$81 million, extinguishing the cash deficit and nearly addressing the total cost of the HKORO. However, we have been advised that the expansion of the registration fee with a commensurate commitment to the HKORO is unacceptable to HKSARG. It would run contrary to the basic principles of government finance in Hong Kong because it would involve ring-fencing funds otherwise destined for the general revenue.

ii. Interest charged on the Companies Liquidation Account

6.14 The costs of this funding mechanism are effectively borne by the creditors of insolvent estates. Whether or not this is appropriate is a policy choice, but the mechanism is well understood and based on the comparable practice in the UK. However, any increase in rates is likely to receive opposition by PIPs and creditors.

6.15 The major attraction of such an approach is its effectiveness. Interest is typically the major income earner for the HKORO, and a significant increase in the rate levied would have an immediate and material impact on financing. The LRC calculated that an increase from 1.5% to 2.5% would have raised an additional HK\$17 million of financing in 1997/8 from the interest earned of HK\$26.6 million³⁰, nearly sufficient to extinguish the cash deficit in that year. The figures for subsequent years would be even more significant, as interest income has risen to HK\$82.2 million in 2001/02.

²⁹ When originally making the recommendation, the LRC noted the significant opposition to a reduction in the Protection of Wages levy, and retracted from that position. This would imply either deduction from the general revenue or an increase in the registration fee.

³⁰ Para 5.19-5.20, Report on the Winding Up Provisions of the Companies Ordinance July 1999.

- 6.16 At present creditors' voluntary and members' voluntary liquidations only have to place funds that are unclaimed or undistributed 6 months after receipt into the CLA. This avoids any interest charges from the HKORO for at least 6 months, and potentially altogether if a dividend is carried out within that timeframe. Requiring funds to be deposited immediately would be another means of increasing HKORO interest income. It would also resolve the logistical complexities faced by liquidators and HKORO in tracking compliance with the 6-month rule. Theoretically it also provides a greater degree of protection for creditors' funds, though in practical terms any PIP set on abusing his position of trust could simply do so prior to depositing these in the CLA. It is not possible to determine the income potential of such a change as there is inadequate data on the additional funds this would pull in.
- 6.17 Whilst we consider that the cross subsidisation of the costs of smaller cases by the assets of others is open to understandable criticism, it is nonetheless a well-understood and highly effective funding technique. An increase in charges should be re-examined as a possible funding mechanism. However, given the variations in interest income dependent on the volume and nature of insolvencies, the HKORO should have alternative sources of funding available in the event of substantial variations in this revenue item.

iii. Increase in fees and petition costs

- 6.18 The Director of Audit has recommended close monitoring of fees levied, with an intention to move towards a system whereby the full cost of insolvency administration can be recovered. Fee increases would be consistent with this recommendation, and it is noticeable that many of the fee scales applied have not been revised (albeit periodically reviewed) for years. However, care would have to be taken that increases in fees, particularly petition costs, which are high in comparison to other jurisdictions, do not end up discouraging access to insolvency services.

iv. Government subsidy

- 6.19 The above recommendations all focus on the private sector bearing cost — either directly through corporate fees, or indirectly by imposing higher charges on creditors. The alternative is for government to absorb the costs of providing a stated level of service, ranging from enforcement activities to providing (either directly or through contract out arrangements) the last resort service. The reality of the current situation is that with a government service defined by statutory obligations, the government cannot avoid incurring certain costs. If revenues are not sufficient to cover these, the shortfall falls to the HKSARG to finance regardless of policy.

v. *Cab rank system*

- 6.20 The introduction of a cab rank system could reduce the financing burden for the HKORO by passing on a significant volume of its case responsibilities to PIPs without public subsidy. The advantages and disadvantages of such an approach have already been discussed. On a purely financial perspective, the biggest question mark over such an approach is whether this is commercially feasible for PIPs without subsidy, given the large proportion of summary cases in the Hong Kong market. The low levels of subsidy sought by some PIPs in the tender scheme give some encouragement that this may be feasible, as does the record in the US.
- 6.21 Passing on some element of the petition fees to PIPs to subsidise their costs would be consistent with practice in the US, and would help limit this problem without incurring public cost. However, we understand that there are practical legal obstacles to the OR doing this at present. As the introduction of a cab rank system would probably require a range of legal changes anyway, this may be a subsidiary issue that can be dealt with in practical implementation of the scheme if it receives adequate support. This would be a major change for the insolvency sector in Hong Kong, however. An extensive public consultation with interested parties, particularly PIPs, is required before its feasibility can be assessed.

Recommendations

We recommend that HKORO's fees should be reviewed and revised as appropriate

- 6.22 Some HKORO fees have not been revised for some time, and others are not cost effective. We consider that the table of fees should be reviewed, and:
- increased to allow for inflation and market costs implemented
 - unnecessary or non-remunerative fee captions eliminated, and the complexity of the ad valorem fees simplified (e.g. to a flat rate, or fewer increments)

Careful consideration should be given to whether the level of bankruptcy petition fees, very high in relation to comparable jurisdictions, constitutes a disincentive to the proper use of bankruptcy and should be reduced.

We recommend that the consultation exercise should be used to explore interested parties reactions to financing alternatives

- 6.23 This should be co-ordinated with the debate over the possible introduction of the cab rank system.

We recommend that the current basis of financial performance evaluation (60% recovery) be changed

- 6.24 The financial evaluation of the HKORO should not be on a strict annual basis, but on a basis that recognises the cyclical patterns of casework and allows the smoothing of costs and revenues across a number of fiscal years. The LRC's recommendation that a "trading account" basis such as that used by the Companies Registry be employed offers a natural balance to the operation of the trade cycle. The HKORO would accumulate reserves built up during recessionary periods where ad valorem fees and income from the CLA are at their highest, to finance their largely fixed costs when the number of insolvencies is far lower.
- 6.25 However, we have been advised that there are practical difficulties with such an approach. Government regulations limit the use of a trading account to operations capable of demonstrating a consistent profit. Whilst the revenue activities of the HKORO could be split off from the costs centres to ensure that this was the case, this would run contrary to the guiding spirit of the ruling. Moreover, there would be no suitable mechanism for releasing excess revenue back into the general reserve — the funds would be trapped within the HKORO. We have been advised that the HKORO is therefore not considered a suitable candidate for a trading fund.
- 6.26 As an alternative, financial performance criteria used to assess the HKORO should be "smoothed" over a number of years to iron out fluctuations caused by caseload variances, even if the actual funding is still on a strict annual basis. The government effectively underwrites the HKORO, so regardless of performance the actual costs will be met.

We recommend that the HKORO explore the possibility of raising additional revenue

- 6.27 Consideration should be given to developing value added services that could form an additional revenue stream for the ORO. The HKORO already charges for information provision such as bankruptcy searches etc. The HKORO should review the range of data available to it and consider what degree of access could be given to it on a fee paid basis beyond that already offered. Opportunities such as an enhanced register of bankrupts and discharged bankrupts, disqualified directors register, and general statistical information on incidences of insolvency by type of business, size of business etc could all be of interest to entities such as credit evaluation agencies. This is obviously dependent on the enhanced computerisation and data management that the HKORO are currently contemplating.

7 Administration

Key Findings

i. The HKORO management information system ("MIS") needs investment

- 7.1 The efficient administration of insolvency cases is key to an ORO agency. We note that in this respect the HKORO is not as fully automated as other insolvency services. This restricts the efficiency of case processing and leads to problems with data storage and retrieval, particularly given the significant increase in caseload recently. Whilst outsourcing will reduce the in-house caseload in future, it will in turn increase the importance of satisfactory systems for monitoring case performance by PIPs.

Recommendations

We recommend that the planned investment in MIS be treated as a priority

- 7.2 The HKORO should proceed with its proposed plan for an updated MIS as a matter of priority. The HKORO needs a system that will integrate case management information as well as the finance and accounting information. In addition, the system should also incorporate standardised forms in order to facilitate the IOs' management of the case files. Such a system could provide multi-user access to case file data and simplify case monitoring, both for in house cases and outsourced work. This offers significant potential increase in operational efficiency, and would be a key step in dealing with the significant increase in caseload experienced.
- 7.3 The Audit Commission's report in 2000 called for performance measures for assessing productivity levels of IOs as well as a monitoring system. By utilising an integrated MIS, variations in caseload can be more easily detected and appropriate performance measures established.
- 7.4 An updated MIS would allow the electronic provision of data on insolvency cases that are currently available only by manual application on a case-by-case basis. The HKORO could then increase their fee income by a wider utilisation of their databases for the dissemination of information about both companies and individuals. In addition, the HKORO could explore providing other information, such as petitions lodged and the names of directors of insolvent companies.
- 7.5 It would be beneficial to have PIPs linked into the revised MIS system. Ideally this would be through controlled online access. This would allow them to electronically file reports and statutory documents, have access to the case file information, and reduce paperwork and delays in accessing data by creditors and the HKORO. If this were not possible a degree of integration could be achieved through providing standard electronic formats and templates for data input and reporting. As well as reducing the manual input of data received from PIPs, integration of PIPs' reporting would ensure consistency of reporting formats and data supplied. In addition, it would make direct monitoring of PIP case progress by the HKORO far easier. Not only would it be possible to determine exact case progress by examining case status online, but PIP handled cases could be integrated into any automated status or exception reporting system.

- 7.6 The introduction of an updated MIS offers major potential advantages to the HKORO. It would not only improve current case management efficiency, but would allow the effective management of PIPs — especially important with the increasing importance of outsourcing. It also allows greater potential for fee income from data mining, although this is subsidiary to the operational efficiencies it would provide. With the current expansion in caseload, and the limited resources available to the HKORO, the advantages of such a system are significant. We strongly support the HKORO's intention to develop and implement such a system, and recommend that the funding of such a program be treated as a priority.