MANAGEMENT OF INSOLVENCY SERVICES

Executive Summary

1. The Official Receiver's Office (ORO) is responsible for providing insolvency services in Hong Kong, including the compulsory winding-up of companies and personal bankruptcy under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (C(WUMP)O – Cap. 32) and the Bankruptcy Ordinance (Cap. 6) respectively. In 2019-20, ORO's estimated expenditure was $223 million, of which $177 million (about 80%) was related to personal emoluments or personnel related expenses. The Audit Commission (Audit) has recently conducted a review to examine the management of insolvency services by ORO with a view to identifying areas for improvement.

Administration of in-house insolvency services

2. According to ORO, under the outsourcing schemes, nearly all winding-up cases and about 25% of debtor-petition summary bankruptcy cases are undertaken by private insolvency practitioners (PIPs). As at 31 December 2019, ORO was working on 20,349 bankruptcy cases (including 15,384 undischarged bankruptcy cases), 190 winding-up cases (carried forward from previous years before all winding-up cases were undertaken by PIPs), 471 outstanding winding-up petitions and 81 winding-up cases on the release programme (para. 2.2). Audit examination has revealed the following areas for improvement:

(a) ***Time target not met for processing summary bankruptcy cases with no monthly contributions but with assets for distribution.*** According to ORO Circular of May 2000, for summary bankruptcy cases with no monthly contributions but with assets for distribution, they should be placed on the release programme within 18 months from the dates of bankruptcy orders. During the period from 2016 to 2018, the annual achievements of the 18-month target for processing these summary cases were below 50%, ranging from 34% to 40%. As the timeliness of processing cases with possible assets for realisation and distribution is a prime concern of creditors, ORO needs to continue to closely monitor the achievement of the

18-month target, and formulate effective strategies for dealing with cases with difficulties in asset realisation in order to meet the target processing time (paras. 2.3, 2.4 and 2.7);

(b) ***Performance target on distribution of dividends not clearly defined.*** As stated in ORO's Controlling Officer's Report, there was a target processing time of nine months relating to distribution of dividends (i.e. "completing procedures when the distribution is possible"). According to ORO's guidelines, the point in time when the distribution is possible (i.e. the starting point for counting the target processing time of nine months) was: (i) the month when the cash balance meets the threshold of $70,000 for a bankruptcy case and $200,000 for a winding-up case; or (ii) the date of receipt by the Dividend Unit when a case with cash balance below the thresholds was referred by the case officer. With a view to clearly defining the performance target on distribution of dividends in the Controlling Officer's Report, ORO needs to specify more clearly in the Report the performance target for completion of procedures for distribution of dividends (paras. 2.9 to 2.11);

(c) ***Clearing exercise of pre-2002 insolvency cases not yet completed.*** In March 2008, ORO commenced an exercise with a view to clearing the outstanding matters of the 1,200 pre-2002 insolvency cases (i.e. cases with date of bankruptcy order or winding-up order before 2002) as soon as possible. However, as at 31 December 2019, more than 11 years after the commencement of the exercise, 200 (17%) pre-2002 insolvency cases (comprising 107 bankruptcy cases and 93 winding-up cases) still remained outstanding (para. 2.12);

(d) ***Need to formulate effective strategies for handling bankruptcy cases involving landed properties.*** With a view to taking more effective follow-up actions in asset realisation, in December 2014, the Project Work Section was set up under the Case Management Division to deal with the majority (i.e. 2,790 cases) of long outstanding landed properties (e.g. residential properties, commercial properties, car parking spaces and land lots) vested in the Official Receiver as trustee in various bankruptcy cases. For other outstanding landed properties that had not been taken up by the Project Work Section in 2014 and the new landed properties vested in the Official Receiver as trustee thereafter, they were handled by individual case officers. Audit noted that, as at 31 December 2019, 1,996 cases remained outstanding. Of them, the bankruptcy orders of 1,565 (78.4%) cases were

made before 2006 (i.e. over 14 years ago). Given that the period of bankruptcy is generally four years (up to a maximum of eight years if the court makes an order under the Bankruptcy Ordinance to extend the bankruptcy), it was not entirely satisfactory that there were a notable number of bankruptcy cases involving landed properties vested in the Official Receiver as trustee for over 14 years but still not yet resolved (paras. 1.8, 2.14 to 2.16 and 2.18); and

(e) ***Large balance in suspense accounts.*** According to ORO's guidelines, for winding-up cases and bankruptcy cases of which the Official Receiver acts as liquidator/trustee, all the company liquidation estates and bankruptcy estates recovered should be placed in the Companies Liquidation Account and the Bankruptcy Account respectively. Interest earned from these estates is transferred to the general revenue annually. Audit noted that as at 30 November 2019, ORO had placed monies recovered from 21 winding-up cases (amounting to $4.7 million) and 207 bankruptcy cases (amounting to $40.2 million) in the suspense accounts. In particular, 8 (38%) of the 21 winding-up cases were released cases and 29 (14%) of the 207 bankruptcy cases were released/rescinded/withdrawn cases. It is less than satisfactory that monies have been put into suspense accounts for a long time pending clarifications, particularly for amounts belonging to the estate of the liquidation or bankruptcy that should have been accounted for in the Companies Liquidation Account and the Bankruptcy Account (paras. 2.22 to 2.24 and 2.26).

Monitoring of private insolvency practitioners

Management of outsourcing schemes

3. At present, ORO operates four outsourcing schemes, including: (a) the Panel A scheme (an administrative scheme for appointing liquidators or special managers in non-summary winding-up cases); (b) the Panel T scheme (an open tender system for appointing provisional liquidators/liquidators in summary winding-up cases); (c) the debtor-petition summary bankruptcy case scheme (an open tender system for appointing provisional trustees/trustees in debtor-petition summary bankruptcy cases); and (d) the preliminary examination scheme (an open tender system for appointing professional firms to perform preliminary work relating to debtor-petition bankruptcy cases handled by ORO). According to ORO, it adopts various measures (e.g. conducting quality audits and field audits) to monitor the

performance of the PIPs under the four outsourcing schemes. If there is a breach of statutory or contractual duties, ORO may take regulatory actions against the PIPs (paras. 3.2 and 3.3). Audit examination has revealed the following areas for improvement:

(a) ***Need to conduct quality audits for Panel T scheme.*** According to the Conditions of Contract of the tenders, ORO will conduct quality audits on the cases allocated to PIPs under the Panel T scheme and debtor-petition summary bankruptcy case scheme. When conducting a quality audit, the case officer examines the adequacy and quality of key areas of the administration work (e.g. applying for summary procedure order and realising assets) performed by the PIP. However, Audit noted that for the Panel T scheme, no quality audits had been conducted up to 31 January 2020 (paras. 3.4 and 3.6);

(b) ***Need to ensure that the target coverage of field audits on cases outsourced under Panel T scheme is met.*** ORO staff are required to conduct field audits of the selected cases outsourced under the Panel T scheme and debtor-petition summary bankruptcy case scheme respectively. Audit noted that for the two most recently completed contracts (covering the period from April 2014 to March 2016 and April 2016 to March 2018) of the Panel T scheme, field audits had been completed on only 3.1% and 2.7% (i.e. 78% and 68% of the target coverage) of the cases outsourced under the two contracts respectively (paras. 3.8 and 3.9);

(c) ***Need to issue warning letters for PIPs' unsatisfactory performance.*** According to the Conditions of Contract of the tenders of the Panel T scheme, the debtor-petition summary bankruptcy case scheme and the preliminary examination scheme, ORO may issue warning letters to the PIPs for their unsatisfactory performance (e.g. failure to submit preliminary examination questionnaires within 7 working days of the interview with the bankrupts). Allocation of cases to PIPs would be suspended for one or two months when a certain number of warning letters have been issued. For PIPs which have been suspended for case allocation for two months or more in the previous two contracts, they will not be considered for tender assessment. However, Audit found that in the period from 2016 to 2019, no warning letters had been issued. Audit also noted that during the period, there were 8 incidents of PIPs of the preliminary examination scheme failing to submit the preliminary examination questionnaires within 7 working days of the interview with the bankrupts

and warning letters could have been issued to these under-performing PIPs according to the Conditions of Contract of the tenders (paras. 3.11 to 3.13 and 3.15); and

(d) ***Need to make continuous improvement in monitoring performance of PIPs.*** According to ORO Circular of October 2013, for cases handled by all PIPs (appointed under the outsourcing schemes, or by the court or creditors), case officers are required to monitor the PIPs' conduct or performance in accordance with the relevant statutory and contractual requirements. Case officers should report unsatisfactory conduct or performance of PIPs in a standard form for central keeping by the Compliance and Regulatory Section. Audit reviewed the registers of unsatisfactory conduct of PIPs, which contained the standard forms completed by case officers and would be reviewed when assessing the past performance of PIPs for tender evaluation, and noted that: (i) while a notable number of liquidator's accounts and trustee's accounts were outstanding from PIPs as at 31 December 2019, no such information was recorded in the registers; and (ii) six substantiated or partially substantiated complaints against PIPs received in the period from 2015 to 2019 were not recorded in the registers (paras. 3.16 and 3.17).

Accounts submitted by PIPs

4. A PIP shall submit an account of his receipts and payments as the liquidator (i.e. liquidator's account) to ORO twice a year. For bankruptcy cases, ORO requires a PIP to submit an account of his receipts and payments as the trustee (i.e. trustee's account) every two years. In submitting the account, the trustee is required to remit to ORO the ad valorem fee, which is charged at progressively reducing rates from 10% to 1% on the aggregate amount of the assets realised. ORO may cause the submitted liquidator's accounts and trustee's accounts to be audited. All accounts shall be filed with the court and made available for inspection by any interested parties upon payment of a fee (para. 3.20(b)). Audit examination has revealed the following areas for improvement:

(a) ***Need to review and enhance follow-up actions taken on long overdue accounts.*** Submission of accounts by liquidators and trustees are statutory requirements stipulated in C(WUMP)O and the Bankruptcy Ordinance. Late submission of accounts to ORO may also lead to delay in remitting ad valorem fees to ORO. Audit noted that as at 31 December 2019, there

were 763 liquidator's accounts and 15,355 trustee's accounts overdue but not yet submitted. Of them, 302 (40%) liquidator's accounts and 146 (1%) trustee's accounts had been overdue for more than five years. Audit also noted that besides issuing reminder letters, no other follow-up actions had been taken by ORO (paras. 3.21 and 3.22); and

(b) ***Need to improve examination/checking of accounts.*** All liquidator's accounts and trustee's accounts submitted by PIPs are subject to an examination of content and accuracy or a cursory checking by ORO. Field audits are also conducted on selected accounts to inspect PIPs' books, accounts and vouchers. However, Audit noted that as at 31 December 2019, 30,972 accounts had been received but not yet examined/checked. Of these 30,972 accounts, 843 (2.7%) accounts had been received for more than five years (paras. 3.23 and 3.24).

Way forward

Modernisation of insolvency provisions

5. In October 1996 and July 1999, the Law Reform Commission of Hong Kong made a number of recommendations to update the local insolvency provisions, taking into account international practices. However, after a long lapse of time, two significant proposals have not yet been implemented. They were: (a) the statutory corporate rescue procedure (i.e. to impose a moratorium during which a company is protected from creditors' action and put under the control of a provisional supervisor whose task is to formulate an arrangement for agreement with its creditors or make other appropriate recommendations) and insolvent trading provisions (i.e. to impose a liability on responsible persons for insolvent trading once a company traded while insolvent or if the company continued to trade when there was no reasonable prospect of preventing the company from becoming insolvent); and (b) cross-border insolvency. As stated in the report of July 1999 of the Law Reform Commission of Hong Kong, the treatment of cross-border insolvency was important in Hong Kong because of its status as an international business and financial centre, given that a large proportion of companies listed in Hong Kong were registered abroad (paras. 1.19, 4.2 and 4.7). Audit examination has revealed the following areas for improvement:

(a) ***Need to introduce the bill on corporate rescue procedure and insolvent trading provisions into Legislative Council in a timely manner.*** In October 2015, the Financial Services and the Treasury Bureau (FSTB) informed the Legislative Council that the target was to introduce the bill on corporate rescue procedure and insolvent trading provisions into the Legislative Council in 2017/18. However, up to January 2020 (i.e. over 23 years since the recommendation of the Law Reform Commission of Hong Kong in October 1996), the relevant bill had not yet been introduced into the Legislative Council (para. 4.6); and

(b) ***Need to sustain efforts in taking forward the domestic cross-border insolvency legislation and conduct public consultation as appropriate.*** In order to provide certainty and align Hong Kong with other major jurisdictions, there has been a strong voice from the insolvency profession and from the court, calling for adoption of specific domestic legislation to deal with cross-border insolvency issues. As the cross-border insolvency matter is a complex subject requiring a careful and comprehensive deliberation, FSTB and ORO should continue to consider how to take forward the domestic cross-border insolvency legislation and conduct public consultation as appropriate (para. 4.11).

Deployment of manpower of ORO

6. ***Need to conduct a strategic review on future manpower deployment.*** Over the years, while there had been more outsourcing of cases and the number of insolvency cases had generally been on a decreasing trend, Audit noted that no staff savings had been achieved by ORO and the establishment of ORO had increased by 49 (22%) from 224 as at 31 March 2010 to 273 as at 31 March 2019. To meet future challenge, ORO needs to conduct a strategic review on future manpower deployment, having regard to the increased regulatory role, the progress of clearing backlog cases and the anticipated increase of insolvency caseload in the coming period (paras. 4.25 and 4.26).

Review of fees structure of ORO

7. ***Need to minimise the impact of fluctuating cost recovery rates on fee charging.*** In line with Government's policy of setting bankruptcy and winding-up fees and charges to recover the total costs for services of ORO as far as possible, it

has been ORO's long established practice to adopt the global costing approach for achieving full cost recovery on an overall basis. In effect, this means that the fees charged in some insolvency cases will be higher than the actual costs incurred to defray the costs of administering other cases where there are no or inadequate assets to cover costs. Audit noted that after ORO's fee revision in 2013, ORO's cost recovery rates had fluctuated notably (ranging from 97% to 326%) and could meet the full-cost target (i.e. from 95% to 105%) only in 2013-14, 2016-17 and 2018-19. In order to address the significant fluctuations of cost recovery rates, in August 2018, ORO completed a preliminary review comparing the fees structures of ORO and insolvency authorities in other jurisdictions (e.g. the United Kingdom) with a view to considering possible options available for FSTB's consideration. However, up to January 2020, ORO had not completed the review of its fees structure (paras. 4.30 and 4.33 to 4.35).

Audit recommendations

8. **Audit recommendations are made in the respective sections of this Audit Report. Only the key ones are highlighted in this Executive Summary. Audit has *recommended* that the Official Receiver should:**

Administration of in-house insolvency services

(a) **continue to closely monitor the achievement of the 18-month target for summary bankruptcy cases with no monthly contributions but with assets for distribution, and formulate effective strategies for dealing with cases with difficulties in asset realisation in order to meet the target processing time (para. 2.27(a));**

(b) **specify more clearly in the Controlling Officer's Report the performance target for completion of procedures for distribution of dividends (para. 2.27(b));**

(c) **formulate effective strategies for clearing the 200 pre-2002 long outstanding insolvency cases as soon as practicable and handling bankruptcy cases involving landed properties (para. 2.27(c) and (d));**

(d) **periodically review the balance kept in the suspense accounts, especially for released/rescinded/withdrawn cases, and take effective measures to ascertain the nature of the funds and transfer them back to the Companies Liquidation Account and the Bankruptcy Account where appropriate in a timely manner (para. 2.27(f));**

Monitoring of PIPs

(e) **implement the procedures on conducting quality audits for the Panel T scheme as soon as practicable (para. 3.18(a));**

(f) **remind the Financial Services Division to take measures to ensure that the target coverage of field audits is met (para. 3.18(b));**

(g) **keep in view the need of issuing warning letters for PIPs' unsatisfactory performance including any prolonged delay in the submission of preliminary examination questionnaires in future (para. 3.18(c));**

(h) **take measures to enhance the reporting and recording of unsatisfactory conduct or performance of PIPs (para. 3.18(d));**

(i) **ensure that the registers of unsatisfactory conduct of PIPs are maintained properly and make continuous improvement in monitoring the performance of PIPs (para. 3.18(e) and (f));**

(j) **review and enhance the follow-up actions taken on long overdue accounts from PIPs and the current procedures on the examination/checking of accounts from PIPs (para. 3.26);**

Way forward

(k) **conduct a strategic review on future manpower deployment, having regard to the increased regulatory role, the progress of clearing backlog cases and the anticipated increase of insolvency caseload in the coming period (para. 4.28(a)); and**

(l) **explore measures to minimise the impact of the fluctuating cost recovery rates on fee charging (para. 4.36).**

9. **Audit has also *recommended* that the Secretary for Financial Services and the Treasury should, in collaboration with the Official Receiver:**

(a) **take action to introduce the bill on corporate rescue procedure and insolvent trading provisions into the Legislative Council in a timely manner (para. 4.12(a)); and**

(b) **continue to consider how to take forward the domestic cross-border insolvency legislation and conduct public consultation as appropriate (para. 4.12(b)).**

Response from the Government

10. The Secretary for Financial Services and the Treasury and the Official Receiver agree with the audit recommendations.