

INVESTIGATION OF INSOLVENT COMPANIES IN HONG KONG: A CORPORATE GOVERNANCE CRISIS*



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The authors discuss a corporate governance crisis in Hong Kong involving the investigation of insolvent companies. Over the last decade the rates paid to insolvency practitioners to handle “summary cases” in liquidation has been steeply declining. At the current rate of HK\$2,558 per case, it is not possible to undertake a proper investigation of the insolvent company. To address this problem, the authors propose that the government consider establishing a special investigations unit.

Introduction

Government officials are frequently heard extolling the virtues of good corporate governance, whilst stressing Hong Kong’s credentials in this regard. Therefore, it may come as a surprise to learn that the government has for a number of years been presiding over an increasingly obvious corporate governance debacle. This undermining of Hong Kong’s corporate governance credentials concerns the proper investigation of businesses that go into insolvent liquidation.

For the government apparently believes that in a typical case a subsidy of HK\$2,558 per case is sufficient to ensure that a full investigation of an insolvent company’s affairs and, in particular, the conduct of its directors, will be conducted. Yes, HK\$2,558 is the going rate for private insolvency practitioners to agree to undertake an in-depth statutory investigation — in a jurisdiction that has some of the highest professional fees in the world! No

* At the time of Philip Smart’s death, Philip, Stephen Briscoe and I were working on this article, which was intended for publication in Hong Kong. This article updates data presented in our earlier publication: *Insolvent Liquidations in Hong Kong: A Crisis of Confidence*, 2007 4(5) *International Corporate Rescue* 263-275.

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wonder there is a growing body of opinion that government policies are helping dodgy directors get away with (corporate) murder.

Investigation of Insolvent Companies

Limited liability, as any lawyer, accountant or business student can tell you, is a pillar of the modern commercial environment. The distinct advantage of limited liability is, of course, that it enables controlling directors / shareholders to run all aspects of a company's business without thereby exposing themselves to liability for the debts of the company should it go bust. The price to be paid for this benefit has always been a level of public disclosure and scrutiny.

Where a company goes under and is liquidated, it follows that there has to be an appropriate level of investigation to ensure that any directors who have cheated creditors, or otherwise breached the law, will be brought to book. Because Hong Kong inherited UK company law, so too Hong Kong used to follow the UK model for investigations. Namely, that the Official Receiver (a government official) would in most cases be appointed to conduct the administration of a company in compulsory liquidation.

Liquidation involves collecting in all the company's assets, settling a list of creditors to whom any dividend might eventually be paid and, of greatest importance, investigating the causes of failure and the conduct of the directors. A proper investigation takes time and resources — it is expensive. The figures given in the Audit Commission Report on the Official Receiver's Office (March 2000) indicate that roughly HK\$80,000 was the average cost to government of each liquidation when these were conducted in-house. Not surprisingly, therefore, the government has sought to contract out liquidation work in an effort to save costs.

Contracting Out Summary Cases

Contracting out liquidation work is relatively straightforward in the big insolvency cases. Because the company has substantial assets, the liquidator knows that his fees (charged on a time cost basis) and expenses will be paid out of those assets (in particular before any money is paid out to creditors). But in small cases, where there are no or virtually no assets left by the time a liquidator steps in, the difficult question is how will a liquidator drawn from the private sector get remunerated? This is a particularly pressing question because over 90% of all liquidations in Hong Kong are small asset cases — these are referred to under the Companies Ordinance as "summary cases". Moreover, in 85% of all summary cases there will in effect be zero assets.

When the Government first started contracting out summary cases, in 1997, it paid a maximum fee of HK\$60,000 to a private sector liquidator: which was a significant saving on the government's previous in-house costs. The fee was reduced in 1999 to \$40,000. Thereafter a tender system — now known as Panel T — was introduced. Under Panel T, firms of (usually) accountants or solicitors submit “bids” specifying the extent of the subsidy they will require to handle batches of for example 20 or 100 summary liquidations. The bid sets out, in effect, what the firm will charge the government to handle each case assuming that there are no realisations from which to meet their fees. The government, as one would expect, accepts the lowest bids.

The following Table sets of the average tender price for the exercises during the period 2001–2008:*

<u>Year</u>	<u>Average Price in HK\$</u>
2001	16,585
2002	11,200
2003	9,200
2004/5	5,500
2006/7	3,100
2008/9	2,558

* From 2004, the tender has been conducted every two years.

The lowest successful bid in the March 2008 exercise was HK\$41,850 for an estimated batch of 93 cases — amounting to an average amount of a mere HK\$450 per case; whilst the highest successful bid was HK\$288,300 — an average amount of HK\$3,100. Thus, the highest bid in 2008 amounted to the average levels overall in 2006/7, and the average figure in 2008, taking all successful bids into account, fell to an all-time low of HK\$2,558. The government might look at these figures and see them as evidence of a great success — in terms of cutting its costs from HK\$80,000 to HK\$2,558 per case. But a liquidation, even in a summary case, ought to require many tens of hours of work from the liquidator and his team. How else can a proper investigation, as required by the Companies Ordinance, be carried out?

Government Policies Create Moral Hazard

In the language of corporate governance, there is a significant “moral hazard” presented to a private liquidator in a Panel T case. Take the all too

familiar scenario where there is some evidence that the directors, with the assistance of a number of friends and relatives, have ripped off the company and its creditors. However, let us assume that some of the directors have already disappeared and the chances of actually recovering assets (out of which the liquidator might be able to recover some of his time costs) are at best very slim.

A proper investigation ought to be conducted to discover: (i) which directors were involved; (ii) what actually happened to the company's assets; and (iii) the role of the implicated friends and relatives. But let us say that such an investigation would require an estimated minimum of 80 billable hours of work, as well as the incurring of considerable out-of-pocket expenses by the liquidator. However, there is no prospect of recovering those expenses, let alone being paid for any of the billable hours. Surely, it is laughable to suggest that a private liquidator can be expected to give away so much of his own time and money in such a scenario. A HK\$2,558 subsidy is patently absurd.

Unscrupulous Directors

In addition, there is anecdotal evidence to suggest that unscrupulous directors are aware of the realities in relation to the investigation of summary cases. Such directors are being encouraged, in effect, to make sure that they spend, take or otherwise run down their company's assets to the lowest possible level before the company goes into liquidation. Why leave the company with HK\$500,000, which can later be used to fund a thorough investigation by the liquidator, when if that money has already been dissipated, the company will fall into the "bargain basement" investigation category?

Many Insolvency Practitioners have stories of being consulted by directors of insolvent companies that have little or no prospect of recovery. In many of these situations, an immediate liquidation would result in a dividend for creditors. However, the directors frequently ignore the advice of the Insolvency Practitioner and continue trading at a loss — with the company eventually being wound up with no assets and therefore no funds with which to fund an investigation.

Government Inactivity

Concerns as to low levels of investigations in insolvency cases were an issue even as long ago as 2002, when the government appointed a consultant

to review the role of the Official Receiver's Office. The consultant highlighted the general perception that insufficient resources were devoted to insolvency investigations. The consultant recommended that a specialist investigations unit should be established by the government to ensure that the more complex Panel T cases were thoroughly investigated. This recommendation received broad public support in the consultation exercise that followed publication of the consultant's report.

Not only has the government not set up a specialist investigations unit, it has in fact allowed the situation to deteriorate drastically by presiding over the current tender arrangements, which have resulted in a system where \$2,558 is supposed to be sufficient to fund a proper investigation.

The Way Forward

The manner in which no asset cases are now contracted out in Hong Kong is unique, as far as the authors are aware. No precedent is to be found in England, Australia or the United States. The Panel T arrangements were initially put in place at a time of severe economic recession in Hong Kong. Whilst everyone is in favour of reducing unnecessary government expenditure, the Panel T system threatens to undermine the credibility of the whole insolvency process. The faults of the current system are glaring — any system that encourages directors to dissipate assets in the run up to the commencement of formal insolvency proceedings is fatally flawed.

No new laws are required. It is simply a question of proper enforcement of the existing laws via appropriate administrative arrangements. There is no need to go back to the pre-1997 position, when all no asset cases were handled in-house by the Official Receiver's Office. But, if some sort of tender process is to be retained, the Consultant's recommendation for the establishment of a specialist investigations unit will have to be given the most serious consideration. We already know, from the work of the inter-departmental task force set up to combat insolvency abuse in the catering sector, that proper enforcement may lead to widespread changes of behaviour by directors. There is every reason to think that a similar commitment from the government can rescue the Hong Kong insolvency regime from its current crisis.

