SHINEWING Specialist Advisory Services Limited

Spring / Summer 2015

e.Bulletin

SHINEWING

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Objection to discharge of bankruptcy – Part Three

By Bianca Poon, Senior Accountant

Background

Mr. X left Hong Kong before his Bankruptcy Order was made in November 2006 and failed to co-operate with the trustee. The trustee objected to the automatic discharge of Mr. X in late 2010 and summoned him for a Court examination in July 2011. In May 2012, Mr. X was arrested under a Prohibition Order and Warrant of Arrest, taken out by the trustee. Mr. X then challenged the application of the Trustee to object the automatic discharged from bankruptcy under Section 30A, Bankruptcy Ordinance (Cap. 6) (BO) and raised the issue of constitutionality in particular on Section 30A(10)(a), BO.

Introduction

In Parts 1 and 2 of the same series, we outlined the statutory framework to object the automatic discharge of a bankrupt under Section 30A of the BO on the basis that the bankrupt left Hong Kong before the making of the Bankruptcy Order and failed to co-operate with the trustee. In the case of Mr. X as detailed in Part 2, the bankrupt challenged the grounds of objection and complained to Court that S.30A, BO is unconstitutional and deprived his right to travel during his bankruptcy period. His arguments were initially rejected at the Court of First Instance but subsequently overturned at the Appeal Court in December 2014. This article summarizes the practical concerns in connection with the constitutionality issues and discusses the possible impact on bankruptcy administrations.

Section 30A(10)(a) of the BO vs. Article 31 of the Basic Law and Article 8(2) of the Bill of Rights

Section 30A(10)(a) of the BO provides that if a bankrupt has, before the commencement of the bankruptcy, left Hong Kong and has not returned to Hong Kong, the 4 years bankruptcy period *(5 years if in case of a repeated bankruptcy)* shall not commence to run until such time as he returns to Hong Kong and notifies the trustee of his return. However, Mr. X argued that his freedom to enter or leave Hong Kong is his basic rights as stipulated in Article 31 of the Basic Law; and Article 8(2) of Bill of Rights provides that “Everyone shall be free to leave Hong Kong”.

The Court of First Instance initially decided that the restriction under section 30A (10)(a), BO is a necessary requirement and upheld the constitutionality of the provision. The Court ruled that it is highly probable a bankrupt’s absence from Hong Kong would effectively mean his cooperation would be unavailable to the trustee’s administration of the bankruptcy estate.

Mr. X appealed to the Court for a declaration that he has been discharged from bankruptcy 4 years after his bankruptcy order made and that s30A(10)(a), BO is unconstitutional, to the effect that he would have been discharged since December 2010.

Unconstitutionality - 3 key considerations

Section 30A(10)(a) was arguably a sanction which restricts the right of a bankrupt to discharge 4 years after the bankruptcy period although the bankrupt was not in Hong Kong at the commencement of the bankruptcy.

The Court of Appeal, having considered and balanced the restrictions imposed by BO and the operational aspect of bankruptcy administration, came to the decision in favour of Mr. X. Three key aspects were considered, and they were:

(i) Section 30A(10)(a), BO discriminated the bankrupt in all circumstances

The Court accepted that the sanction covers all adjudged bankrupts having any reasons of absent from Hong Kong. However, the extreme situations of absence from Hong Kong because of health deterioration, detention in mainland China and willful default of the bankrupt are all regarded the same, without specific consideration of each situation. The sanction operates even if the bankrupt is absent from Hong Kong but remains contactable and has provided the trustee with information by emails or by post. This brings up the next aspect of the Court's consideration.

(ii) Difficulty with bankruptcy administration

The Official Receiver and the trustee argued that unless the bankrupt returns to Hong Kong, it will be extremely difficult, if not impossible, to interview the bankrupt for realization of his bankruptcy property without the sanction of Section 30A(10)(a). Absence of this sanction would render the trustee impossible to conduct face-to-face interview or preliminary examination with the bankrupt to confirm his identity and to obtain financial information in relation to his assets.

However, the Court held that any restriction to travel before the commencement of the bankruptcy order, with a view to achieving the administration of the bankruptcy estate is unnecessary. The sanction has ignored circumstances where the bankrupt might not be interviewed by the trustee but by other means do satisfactorily co-operate with the trustee in bankruptcy.

(iii) Departure before commencement and abuse

In response to the appeal of Mr. X, the Official Receiver submitted that 90% of the undercharged bankrupts, who were caught by section 30A(10)(a), have not returned to Hong Kong since they left prior to the commencement of bankruptcy. Should section 30A(10)(a) be declared unconstitutional, 90% of these 'absconded' bankrupt would have been automatically discharged even though they have done nothing to comply with the BO before their discharge.

The Court, however, held that section 30A(10)(a) is not the only provision which would prevent the abuse of the statutory scheme. For example, objection of the automatic discharge from bankruptcy would prevent the automatic expiration of bankruptcy.

Practical issues to resolve

The current decision of the Appeal Court would fuel further difficulties in bankruptcy administration if the bankrupt intentionally left Hong Kong before the commencement of a bankruptcy. From our experience, practical issues may arise in the following areas:

- Obviously the trustee is a complete stranger to the bankrupt in most situations where the identity of the bankrupt would not be verifiable in the absence of an interview.
- Absence of an interview with the trustee may deprive the rights of the bankrupt to understand his duties during his bankruptcy and hence may be excusable grounds for non compliance with provisions of BO.

- Advancement of electronic communications (by emails or otherwise) would not assist the trustee to identify with whom they are in connection with and hence the authenticity of information obtained.

- BO provides that the bankrupt should assist the trustee to realize bankruptcy estate in Hong Kong and elsewhere where possible including giving necessary assistance as may be required in the course of assets realization. Trustee could hardly obtain timely information and feedback from the bankrupt to secure control over realizable assets or stop possible dissipation of assets.

- Objection to discharge is a powerful statutory regime to discourage bankrupt from not giving assistance to the trustee. However, it would not actively assist the trustee to administer bankruptcy estate. In many cases that we have handled, bankrupts have challenged the grounds for objection to discharge despite their weak defence without merits. Additional time and costs were incurred for the Court and the trustee to deal with these delay tactics.

Conclusion

While the Court of Appeal held that section 30A(10)(a) is unconstitutional for the time being, the Court granted a stay of execution of the judgment. Since then, it is noted that in April 2015 that an application for leave to appeal to the Court of Final Appeal was made by the Official Receiver's Office. The unconstitutional issue is apparently of public interest and may have far reaching impact on bankruptcy administration. We shall update readers the final outcome in our coming e-Bulletin.

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Epilogue: Bankruptcy (Amendment) Bill 2015

Introduction

The constitutionality issues of S.30A(10) have been debated in a number of bankruptcy cases. On 30 April 2015, the **Bankruptcy (Amendment) Bill 2015** was published in the Gazette. The amendments are proposed to deal with the automatic suspension of the running of the period of time (4 years for first time bankruptcy and 5 years for repeated bankruptcy) (**Relevant Period**) after which a bankrupt is discharged from bankruptcy under the Bankruptcy Ordinance (Cap. 6) (**BO**). The proposed amendments will be in effect on 1 November 2016. Before that, the existing relevant provisions under S.30A(10) of the BO will continue in operation for those bankruptcy cases which order is granted before 1 November 2016.

Existing provisions

Under certain circumstances, the Relevant Period would "stop" from running (S.30A(10), BO):

- Where a bankrupt has left Hong Kong and not returned *before* his/her bankruptcy order was made, the Relevant Period *shall not start to run* until he/she returns to Hong Kong and *notifies* the Trustees of his/her return (S.30A(10)(a), BO *(note(1))*;

- Where a bankrupt has left Hong Kong *after* his/her bankruptcy order was made but:
  - without notifying the Trustees of his/her itinerary and contact details (S.30A(10)(b)(i), BO) *(note(2))*; or
  - fail to return to Hong Kong on a date or within a period specified by the Trustees (S.30A(10)(b)(ii) , BO),

then the Relevant Period shall *cease* to run during the period of his/her absence from Hong Kong and will resume again when he/she *returns* to HK and *notifies* the trustee of his/her return.

The proposed amendments

Under the new proposed amendments (under S.30AB, BO), a new order, **Non-Commencement Order (NCO)** is required to "stop" the running of the Relevant Period. The trustee may apply to the Court for a NCO against a bankrupt if:

S.30AB(1)(a) - the trustee has required the bankrupt to:

- attend an initial interview on a day appointed by the trustee for the administration of the bankrupt's estate; and
- provide the trustee at the initial interview with information concerning the bankrupt's affairs, dealings and property,

S.30AB(1)(b) - the bankrupt has:

- failed to attend the initial interview; or
- attend the initial interview, but failed to provide the trustee at the initial interview with all of the information concerning the bankrupt's affairs, dealings and property as reasonably required by the trustee; and

S.30AB(1)(c) - the administration of the bankrupt's estate was prejudiced by the matters referred to in S.30AB(1)(b) above.

The NCO has to be applied within 6 months after the date of the bankruptcy order against the bankrupt; or a longer period specified by the Court an **Extension Application** by the trustee.

The Extension Application must be made within the 6-month period after the date of the bankruptcy order against the bankrupt or unless the Court order otherwise.

If the Court is satisfied the application made by the trustee under s.30AB(1), a NCO would be ordered.

A NCO must specify the relevant period for the bankrupt is treated as "not commencing to run" and also the terms that the bankrupt must comply with before the relevant period is to commence to run.

If the terms specified in the NCO are complied with by the bankrupt, the trustee must, within 14 days after the date on which all such terms are complied with:

- file with the Registrar a notice stating the fact and the date on which all such terms are complied with (**the Notice**); and
- send a copy of the Notice to:
  - the bankrupt; and
  - the Official Receiver

On the trustee's filing of the Notice, the relevant period is treated as commencing to run on the date stated in the Notice.

This Bill have been introduced into the Legislative Council for first and second readings on 13 May 2015.

Note

(1): This provision was held by the Court of Appeal as being unconstitutional in a bankruptcy case. In April 2015, the Court of Appeal granted the Official Receiver leave to appeal to the Court of Final Appeal and execution of the judgment has been stayed pending the result of the appeal.

(2): This provision was declared unconstitutional by the Court of Final Appeal on 20 July 2006 (Official Receiver & Trustee in Bankruptcy of Chan Wing Hing & Anor v Chan Wing Hing & Anor & Secretary for Justice (2006) 9 HKCFAR 545, FACV Nos. 7 and 8 of 2006).

Audit evidence – how much is adequate?

By Anita Hou, Partner

Foreword

Some people say an audit is based on "professional judgment". Although there are auditing standards and guidelines issued by regulatory or professional bodies that regulate or guide the auditors when conducting auditing work and issuing audit opinions, judgment still plays an important role especially when deciding what and which audit procedures to conduct, what evidence to obtain, and how audit conclusions are being drawn.

What do you think about the following case?

The Case

This is a professional negligence case that involving auditors.

It is alleged that the auditors did not perform *appropriate* audit procedures and obtain *adequate* audit evidence to verify the ownership of a U.S. listed company over its PRC subsidiaries and hence, the auditors were not able to identify the unauthorised (and illegal) transfer of equity interests of one of the major subsidiaries (in fact, it is the most significant and the only operating subsidiary of the listing group) to external parties by its senior management. The financial results of this subsidiary were continuously (and wrongly) consolidated into the group's financial statements for a number of years.

The unauthorized transfer remained un-discover for a number of years until one of the independent investors performed company searches on the PRC subsidiary and found that the equity interests of this subsidiary had been transferred, not once, but twice during the past few years; first to a related company of the senior management and then to another external third party.

The most astonishing fact is that the auditors, who have audited the listed company's financial statements and expressed clean audit opinions for all these years, did not identify such unauthorized transfer at all. Legal action was therefore taken out by some of the shareholders of the U.S. listed company against the auditors for their negligence in conducting the audits.

The Defences

The auditors' key defences are:

- they have performed overall risk assessment on the audit, and based on *their prior experience and professional judgment*, designed the appropriate audit procedures;
- they have conducted *adequate and appropriate audit procedures* to confirm the ownership issue, e.g.
  - reviewed the business licence of the PRC subsidiary and noted that there was no change of ownership in the subsidiary *(author's note: a PRC business licence only shows the scope and nature of the business of a company; it does not show any details of the shareholders or ownership etc)*;

  - enquired with the management and were advised that there was no change of group structure;
  - reviewed all the board minutes and noted that there was no change of group structure and ownership in subsidiaries;
- they were not aware of any matters that leading them to raise doubt on the integrity of the management, and so as the reliability of audit evidence provided by them. No "additional" audit procedures, in particular for ownership of subsidiary, were therefore considered necessary. They simply followed the usual "standard" audit procedures conducted in prior years.

The Arguments

The shareholders' key arguments are:

- based on the available published records, it is noted that the auditors were all the years aware of the deficiencies in the group's internal controls, and there were high risks of management dominance over the operations and management overriding controls;

- the auditors have knowledge of past non-compliance of rules and regulations by the management;

- there were widespread negative and fraud news for companies with similar listing status and set up as this U.S. listed company;

- in the circumstances, the auditors failed to consider obtaining *independent / third parties audit evidence* (e.g. performing company searches on the PRC subsidiary), which is always considered to be more reliable evidence to support the audit objectives (and hence the audit opinions) of the auditors, to confirm such significant ownership issue;

- given the unauthorized transfer was happened few years ago and remained undiscovered, it suggested that the auditors did not bother to independently confirm the ownership of this significant subsidiary and consider its impact to the group, but simply relied on the *misrepresentations from the management*, for all years.

It is surprising to note that, just a simply company search by an investor (who is not even a lawyer, auditor, and no need to have any authority from the management or the listed company) can discover the authorized transfer. How could all the audit procedures carried out by the auditors for all those years not discover the authorized transfer?

The Discussion

Further to the representations given by the management and all those internal generated documents (e.g. board minutes), whether the auditors should perform independent company searches are subject to argument or "professional judgment". One may argue that, since there is no indication of otherwise, why should auditors perform "additional" procedures to verify the ownership issue. The other may argue that, given the significance of the subsidiary to the group, the auditors should proactively obtain independent and reliable audit evidence to confirm the ownership.

The same type of audit procedures may be applicable to a great variety of companies, but are not necessarily applicable to the company that an auditor is currently working on. Similarly, the same type of audit procedures may be applicable to a particular company in prior years, but are not necessarily appropriate in any subsequent year.

Hence, for each and every audit, an auditor needs to apply his "professional judgment" after taking into account all the relevant facts and circumstances that surrounding the company, including new information that the auditor encounters during the course of the audit.

The Remarks

As auditors, it is required that he/she should:

- maintain professional skepticism throughout all aspects of the audit including his/her analyses of audit evidence, and, in particular, to management's representations and evidence prepared or provided by management to the auditors;

- consider the potential of management to override accounting controls and recognise that the audit procedures which are effective for detecting errors may not be able or effective to detect material misstatements due to fraud;

- design and perform further audit procedures to address material risks of misstatement;

- assess the reliability, sufficiency and appropriateness of audit evidence; if there is any doubt on the reliability of audit evidence, additional audit procedures need to be carried out;

- not use management representations as a substitute for other audit evidence which can be obtained on a reasonable basis.

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Diary of Nick

Employer went bust – when employees can get their money back?

I met my buddy Peter last night during Happy Hours and was told that his employer company has been ordered to wind up recently because of cashflow difficulties and disputes with certain suppliers. Peter was so worried that once the company is wound up, all the assets will be frozen and forced to sale and in view of the significant government tax liabilities, no assets and funds would be available to repay outstanding debts to the suppliers and worst of all, the salaries of employees like him.

I felt sorry about Peter's situation. As I know, his company was doing well in the past decades and most of the employees had worked there for long time; their relationship was closed and really like a family. Peter said his boss has tried to re-employ these long-term employees using his other group companies, however, there are still significant outstanding salaries and severance payments to be settled. I reminded Peter to seek assistance from the Labour Department, and immediately make application to the Protection of Wages of Insolvency Fund Board (PWIF) for certain ex-gratia payments.

PWIF

PWIF was in operation since 1995 to assist employees whose employer became insolvent and was not able to make payments to the employees. Upon a winding-up petition has been presented (if the employer is a company) or a bankruptcy petition has been presented (if the employer is an individual) against the employer, the affected employees may apply for ex-gratia payment from PWIF in respect of wages in arrears, pay for untaken annual leave, pay for untaken statutory holidays, wages in lieu of notice and/or severance payment etc owed by the employer.

According to the Protection of Wages on Insolvency Ordinance, the ex gratia payment that may be made out of PWIF includes:

- *arrears of wages – outstanding wages in respect of services rendered during the period of 4 months prior to the last day of service, pay for statutory holidays taken, maternity leave pay and sickness allowance, end of year payment etc (cap at HK$36,000)*
- *wages in lieu of notice - up to the equivalent of 1 month's wages (cap at HK$22,500)*
- *severance payment (cap at HK$50,000 plus 50% of any excess entitlement)*
- *pay for untaken annual leave and untaken statutory holidays (cap at HK$10,500)*

Apart from the PWIF, I reminded Peter that, according to Section 265 of the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap. 32), certain employee entitlements are with preferential payment priority that could be paid in advance of statutory debts. It is therefore no need for Peter to worry that assets of the company would be all paid to the government before payments to the employees. However, for those employee entitlements that do not fall into the preferential payment priority, they need to be ranked similar to those unsecured creditors where repayment is uncertain. Depending on the assets and realizations of the liquidation, and payments ranked ahead of the unsecured claims (e.g. liquidators' fees and other liquidation expenses), the unsecured creditors (including the employees' claims that do not fall into preferential claims) would be paid. After hearing what I said, Peter together with his mixed feelings of grief and joy, hurried to the Labour Department for further information.

Nick is an experienced insolvency practitioner that handled different types and cross-border restructuring, company liquidation and personal bankruptcy cases.

Market updates

China announced three new Free Trade Zones in Tianjin, Guangdong and Fujian

China - On 12 December 2014, the Chinese government has been given the authorization from the top legislature to ease investment rules in three new free trade zone (FTZs), namely Guangdong province, Fujian province and Tianjin. Currently, the only FTZ operating is in Shanghai which was launched in September 2013. According to the resolution passed by the National People's Congress Standing Committee, foreign companies do not need to obtain government approvals to set up ventures, shut down and merge ventures or change business purposes within these three new FTZs. Foreign companies will only need to report their business plans to the authorities.

Such preferential policies will be implemented on a temporary basis in the three new FTZs, starting from March 2015 and will last for three years. The State Council will decide whether to propose a law revision or return to the original regulations after the 3-year period.

Procedures streamlined for companies planning to seek funds in overseas markets

China - The China Securities Regulatory Commission (CSRC) is streamlining the administrative procedures to facilitate domestic companies seeking to list overseas, undertake mergers or open banking facilities. New measures was announced on 19 December 2014 include Chinese companies will no longer need to provide audit results or environmental protection certificates when seeking to go public abroad. In addition, certain unpopular preconditions for overseas investment are now being scrapped. For example, the government will now allow investors to transfer money directly to target companies abroad and register cooperation projects through banks. Before the introduction of the new measures, companies are required to obtain government approval for such deals.

The CSRC also confirmed the required application materials for issuing new common or preferred shares abroad.

Launch of Full Scale Electronic Filing Service @ e-Registry

Hong Kong - Company Registry (CR) announced the launch of a full scale electronic filing services at the "e-Registry" on 3 March 2015.

"e-Registry" is a 24-hour portal developed by the CR which provides five service areas: Electronic Submission of Applications and Specified Forms, One-stop Registration and Notification Services, Annual Return e-Reminder Service, Registration of Registered Agent Service, and e-Monitor on new documents submitted by interested companies. The full scale electronic filing services at e-Registry cover a total of 84 specified forms.

The new filing service is aimed to enable companies to comply with their reporting obligations more efficiently and make up-to-date company information available for public inspection readily, which in turn also enables users to enjoy efficient, fast and user-friendly electronic services.

News

Hong Kong Institute of Certified Public Accountants (HKICPA)

Terry Kan and Anita Hou, partners of SAS, were invited to speak on topics relating to insolvency administrations in Hong Kong for the insolvency courses organised by the HKICPA in December 2014 and May 2015.

Hong Kong Journalists Association

On 13 April 2015, Terry and Roy Lo, the Managing Partner of SHINEWING (HK) CPA, were invited by the Hong Kong Journalists Association to share their experience in understanding the warning signs of corporate financial crisis, the available corporate rescue options and hot topics in recent PRC reorganization cases. The 2.5 hours workshop: ***When corporations face with financial crisis*** was attended and well-received by journalists from major local English and Chinese press.

Hong Kong Institute of Chartered Secretaries (HKICS)

Anita was invited by HKICS to have a joint seminar with Messrs. Howse Williams Bowers in October 2014 on ***Preventing, Detecting and Reacting to Corporate Fraud***, with around 70 participants attendance. Anita and representatives of Messrs Howse Williams shared with the participants their experience and practical tips in dealing with fraud related issues.

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ACCA Hong Kong

Anita was invited as one of the speakers of the ACCA/CSSA Career Forum in January 2015. This is the 3rd year that ACCA Hong Kong jointly organises the Career Forum with the Joint Committee for Mainland Student & Scholar Associations in HK Universities. In the past 2 years, the Forum had attracted overwhelming participation from over 120 mainland Chinese business students and received very positive feedbacks.

Anita was also a speaker in a sharing session co-organised by ACCA Hong Kong for university students in City University of Hong Kong in November 2014. She shared with the students her career development, knowledge and practical experience in working as an forensic accountant.

ACCA / Macau CRAC

Anita spoke in a seminar organised by ACCA/Macau CRAC in April 2015 on topic relating to ***Corporate Frauds: Challenges and Solutions***. Over 100 participants attended the seminar which covered the following discussions:

- A recap of common fraud schemes
- Update on recent fraud cases
- Challenges for cross-border cases
- Reacting to fraud – a holistic approach

For those of you who are interested to explore our seminars such as liquidation and restructuring, forensics and digital investigations, as well as mergers and acquisitions, please do not hesitate to contact us at sasmarketing@shinewing.hk to arrange for a tailored session.

Feedback from readers is essential to our success. We welcome and value your comments or suggestions. Feel free to contact us for any questions as well.