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Liquidation and Insolvency

Guidance Note (2)

- An insolvency practitioner's investigation into the affairs of an insolvent company



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

STATEMENT 1.601

LIQUIDATION AND INSOLVENCY GUIDANCE NOTE (2) – AN INSOLVENCY PRACTITIONER'S INVESTIGATION INTO THE AFFAIRS OF AN INSOLVENT COMPANY

(Effective as from 1 August 2020)

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Introduction

1. This Liquidation and Insolvency Guidance Note ("LIGN") should be read in conjunction with LIGN (1) – *Scope*.
2. This LIGN has been prepared for the use of insolvency practitioners¹ ("IPs") in connection with liquidations of companies under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("CWUMPO"). IPs are reminded that LIGNs are issued for the purpose of guidance only and may not be relied upon as definitive statements. They do not affect any responsibilities that may be imposed by law or regulations.
3. This LIGN concentrates on the duty of an IP of an insolvent company to investigate the company's affairs. The IP is expected to carry out a minimum level of work procedure, whether there are assets or not, and creditors should be confident that the investigation duty has been properly discharged.
4. The purpose of an investigation is to determine the assets and liabilities of the company and to review the conduct, decisions and actions of the directors. If, during the course of the investigation any apparent preferences, transactions at undervalue, dispositions of property after the commencement of the winding-up, or rights of action come to light, the IP should determine, if necessary with the benefit of legal advice, whether or not any particular transaction can be set aside.
5. An IP should carry out investigations that are proportionate to the circumstances of each case. The extent and nature of the investigation work will vary from company to company but should include the procedures mentioned below.
6. No liability attaches to the Council of the Institute or anyone involved in the preparation or publication of the LIGNs.

Procedure

Seeking information

7. At the outset of the winding-up, all relevant directors, including directors who held office during the last three years, the company secretary and other senior officers should be questioned as to the company's affairs, including the reasons for failure. The onus is on the IP to consider carefully which directors, officers, former directors or shadow directors are relevant, having regard to the extent of their prior involvement with the company and their accessibility, the publicity surrounding the insolvency and the information that the IP believes they may have.
8. Where appropriate, the IP may also wish to invite creditors and other relevant parties to provide information on any concern regarding the way in which the company's business has been conducted and on potential recoveries for the estate, and also to bring to the IP's notice any particular matters which they consider require further investigation.

Accounting records

9. Once appointed, the IP must try to ascertain the location of the accounting records (kept in whatever form) belonging to the company and take steps to safeguard them. Given advancements in information technology, the IP should take steps to ensure that relevant electronic data is properly captured and stored.
10. The accounting records of the company (including data kept in electronic form) covering a minimum of the previous two years (subject to availability), or such longer period as the IP may consider appropriate, or as may be required (see paragraph 16 below) in the circumstances, should be examined to ensure material transactions in the final period of trading were made in the normal course of business. The nature of the investigation undertaken will depend on the

¹ Refer to paragraphs 4 and 5 of LIGN (1) for the definition of an insolvency practitioner.

records and the form in which they are available, as well as the particular circumstances of the administration.

11. An IP should always have in mind the need to ascertain, or if necessary investigate, what assets can be realised and whether prior transactions by the company could give rise to an action for recovery under the relevant legislation. A review of the company's accounting records may highlight a preferential payment to a particular party or the acquisition or maintenance of a particular asset not previously disclosed in the financial statements, or dispositions of property that are automatically void by reason of the commencement of winding up. This examination may include a review of the general ledger, for unusual transactions, paying particular attention to director and related-party accounts. The accounting ledgers may also be reviewed in conjunction with cash books, bank statements and cheque books, and material amounts vouched to one another. This may help detect unrecorded payments/ receipts and assist the IP in assessing the accuracy and completeness of the records, and hence the reliability of the company's accounting function prior to liquidation. It should be noted that as the company's accounting records may be in electronic form, the IP should apply relevant tools and technology to assist in the review process.
12. Where the IP cannot obtain accounting records for the period prior to liquidation from the company, consideration should be given to obtaining records from other sources, wherever it is reasonably practicable to do so. For example, the IP should consider requesting copies of bank statements from the company's bankers and details of particular receipts and payments, as appropriate and as soon as possible. Consideration should also be given to requesting information regarding the company's affairs from creditors and other parties who may be able to provide such information.

Validity of charges

13. Details of all security held by banks and other parties should be obtained and the IP should check the registration and consider the possible invalidity of any charge. Where the liquidation follows a receivership, the validity of the receiver's appointment should also be assessed.

Comparison of assets with last statement of financial position

14. For the purposes of discovery of assets, where relevant, the statement of affairs should be compared with the most recent audited financial statements and management accounts. The IP should be satisfied that material movements in fixed and current assets can properly be explained. Where no statement of affairs is provided, the most recent audited financial statements and management accounts should form the starting point for identifying assets owned by the company.

Trading losses

15. Consideration should be given to the preparation of a deficiency account and, possibly also, a statement of comprehensive income, in any case where there is a material difference between the deficiency disclosed in the statement of affairs/ supplementary affidavit(s) and the last audited financial statements, after taking into account matters such as writing-down of asset values.

Transactions with associated companies or connected persons

16. The accounting records of the company should be examined for a minimum of two years (subject to availability) to ensure that any transaction with associated companies or connected persons were carried out at arm's length, and material transactions should be examined in detail. Particular attention is drawn to transactions involving directors, including any reduction in loan accounts and/ or reduction in overdrafts supported by personal guarantees. Repayment terms of director loans should be noted and any material acquisition of assets by or disposal to directors and related parties, or transaction which might constitute the giving of any preference to that director or related party in the two-year period preceding the liquidation, should be investigated in detail, to determine whether the transactions occurred on commercial terms. It should be noted

that, for investigations into transactions at an undervalue, the relevant period of review should be the past five years.

Company records

17. The company records (i.e., any register, index, agreement, memorandum, minutes or other documents) required by the Companies Ordinance (Cap. 622) to be kept by the company should be examined, and compared with a search obtained from the Companies Registry. Particular attention should be given to the identity of directors who held office during the past three years.

Reporting to creditors

18. Creditors should be given information regarding investigations, any action being taken, and whether funding is being provided by third parties. Disclosure would be subject to considerations of privilege and confidentiality and whether investigations and litigation might be compromised. The times at which such information should be provided to creditors could vary from case to case.

Record keeping

19. An IP should document, at the time, information collected from relevant parties, investigations and conclusions, including any conclusion that further investigation or action is not required or not feasible, and also any decision, with justifications, to restrict the content of reports to certain parties.

General

20. The IP's investigation into the affairs of the company should aim to identify any rights of action that the company, or the IP, may have against third parties and, while this is not an exhaustive list, attention is drawn in particular to the following provisions:

Companies Ordinance (Cap. 622)

Sections 205-207, 274-275, 277-282, 286-289	Solvency and financial assistance
Sections 373, 374 and 377	Failure to keep or preserve accounting records
Section 480	Bankrupt acting as a director

Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)

Sections 47A – 48*	Financial assistance
Section 121*	Failure to keep or preserve any books of account
Section 156*	Bankrupt acting as a director
Section 157J*	Criminal penalties for contravention of Section 157H (Prohibition of loans, etc., to directors and other persons)
Section 182	Avoidance of dispositions of property of the company after commencement of winding up
Section 190(5)#	Failure to submit a statement of affairs
Sections 212-214	Uncalled capital
Section 265D#	Transactions at an undervalue
Sections 266/266B#	Fraudulent/ unfair preferences

Section 271	Offences by officers of companies in liquidation
Section 272	Falsification of books
Section 273	Frauds by officers of companies which have gone into liquidation
Section 274#	Failure to keep proper books of account
Section 275	Fraudulent trading
Section 276#	Misfeasance and misapplication etc. of property
Section 277	Prosecution of delinquent officers and members

*repealed but continue to apply by virtue of Schedule 11 to Cap. 622 or section 23 of the Interpretation and General Clauses Ordinance (Cap. 1) or both

for the transitional and saving provisions regarding amendments made by the Companies (Winding Up and Miscellaneous Provisions)(Amendment) Ordinance 2016, see Schedule 26 to CWUMPO or section 23 of the Interpretation and General Clauses Ordinance (Cap. 1) or both

Conveyancing and Property Ordinance (Cap. 219)

Section 60	Voidability of dispositions to defraud creditors
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Consideration should also be given as to whether any other rights of action are available, for example, in relation to the common law fiduciary duties of directors, breach of constructive trust, etc.

21. Where a committee of inspection has been set up, the IP should, where appropriate, obtain the sanction of the committee in respect of any decision to bring, or defend, any action or other legal proceedings, in the name of and on behalf of the company, following the outcome of the above investigation work. This sanction is a statutory requirement in a compulsory winding-up. In all cases, the overriding consideration will be the likelihood of any tangible benefit to the creditors. Where there is no committee of inspection, in a compulsory winding-up, sanction should be sought from the court or the Official Receiver, as appropriate.
22. If it should come to the notice of the IP, in the course of a winding-up, that any past or present officer (or member) of the company may be guilty of any offence in relation to the company for which the officer is criminally liable, then, in a compulsory winding-up, the IP should report the matter to the Official Receiver. In a voluntary winding-up, the IP's duty is to report the matter to Secretary for Justice (section 277, CWUMPO).
23. Attention is also drawn to the requirement that the IP must report on the conduct of the directors to the Official Receiver. Please refer to LIGN (4) – Disqualification of directors – statutory reports.