

For discussion
26 April 2005

LegCo Panel on Manpower

Prevention of Abuse of the Protection of Wages on Insolvency Fund

Purpose

To seek Members' views on measures being considered to further prevent abuse of the Protection of Wages on Insolvency Fund (the Fund). Subject to Members' views, the Administration will undertake in-depth study of the proposed measures.

Background

2. The Fund was set up in 1985 to provide timely relief in the form of ex-gratia payment to employees of insolvent employers. Employees who are owed wages, wages in lieu of notice and severance payment by their insolvent employers may apply for ex-gratia payment from the Fund. The maximum payment for each employee is \$36,000 of wages, \$22,500 of wages in lieu of notice and severance payment up to \$50,000 plus 50% of the remainder of the entitlement. The maximum amount of payment that each person would receive is \$278,500.

3. The Fund received 13,631 applications in 2004, down a significant 39% on 2003. The number of applications received by the Fund broken down by industry is as follows:

| Major Industries | Number of Applications | |
|-------------------|------------------------|---------------|
| | 2003 | 2004 |
| Catering | 9 095 (41%) | 5 333 (39%) |
| Construction | 4 351 (20%) | 3 317 (24%) |
| Import/Export | 1 069 (5%) | 942 (7%) |
| Retail | 966 (4%) | 592 (4%) |
| Business Services | 961 (4%) | 344 (3%) |
| Others | 5 908 (26%) | 3 103 (23%) |
| Total | 22 350 (100%) | 13 631 (100%) |

4. The Fund had been in deficit since the Asian financial turmoil in 1997 until the 2004/05 financial year when it recorded a surplus. As at the end of the financial year, the accumulated surplus of the Fund amounted to \$96.3 million. The total amount of ex-gratia payments made by the Fund in 2004/05 amounted to \$315.8 million. The Fund is financed by a \$600 levy imposed on Business Registration Certificates. The levy was last increased by \$350 from \$250 to \$600 in 2002. The Fund is operated by the Labour Department (LD).

5. Payment of outstanding wages of employees in insolvency cases has all along been the primary objective of the Fund, and its importance is growing. In 2002/03, wages accounted for 43% of total payments from the Fund, and the proportion increased to 57% in 2004/05. Over the same period, the proportion of payments attributable to severance payments (SP) dropped from 43% to 31%. The remaining proportion of payments from the Fund covered outstanding entitlements to wages in lieu of notice, which amounted to 14% in 2002/03 and 12% in 2004/05.

6. The drop in the proportion of payment of SP by the Fund is largely due to the fact that under the Mandatory Provident Fund (MPF) Scheme, employer's contribution to the MPF can be used to offset their liability under SP. With the passage of time, the need for the Fund to make ex-gratia payment to cover outstanding SP will gradually diminish. It is envisaged that in the long term, payments from the Fund will mainly cover outstanding wages in default, rather than SP.

Measures Already in Place to Prevent, Detect and Deter Abuse

7. The Administration attaches great importance to protecting the Fund against any possible abuse. To this end, the LD has put in place a sound mechanism and will review the need to strengthen it from time to time. The following measures have already been adopted to guard against possible abuse :

(a) Requirement of provision of truthful information

Every applicant is required to make a statutory declaration before the Commissioner for Oaths when submitting the application, failing which his application would be rejected. The employer concerned is also required to produce relevant documents and information to assist the LD in processing the application. Under section 26 of the Protection of Wages on Insolvency Ordinance, any person who provides false information/documents commits an offence and is liable to a fine of \$50,000 and imprisonment for three months.

(b) Stringent vetting procedures

On receipt of an application, the LD would check against its comprehensive computer databases of past claims to the Fund. These databases contain both information relating to all previous applicants who have applied for ex-gratia payment and also that of their employers, including directors, proprietors and partners of the company concerned. The stringent checking aims at detecting duplicate or dubious claims. Where necessary, the LD will verify the information provided by the afore-mentioned parties with the Inland Revenue Department, the Mandatory Provident Fund Schemes Authority and other government departments. The information on directors who appear in the database twice in any five years will also be referred to the Official Receiver's Office (ORO) for consideration of director disqualification.

(c) Setting up of a special investigation team

In May 2003, a dedicated team comprising experienced labour officers was set up in the LD to conduct in-depth investigation into dubious applications. It also serves as LD's focal point of contact with the Commercial Crime Bureau (CCB) of the Hong Kong Police Force or the ORO in investigating suspected cases involving abuse of the Fund. If offences such as illegal transfer of assets,

fraud, or conspiracy to defraud are suspected to have been committed, it will refer the case, where appropriate, to the CCB or the ORO for investigation.

(d) Proactive involvement in liquidation process

The LD assumes a proactive role in attending creditors' meetings in large insolvency cases with a view to closely monitoring the liquidation process. It also maintains close liaison with insolvency practitioners to prevent possible abuse of the Fund.

(e) Stepping up prosecution of wage offences

In September 2002, the LD set up the Employment Claims Investigation Division to step up prosecution of employers who fail to discharge their obligations under the Employment Ordinance. Rigorous enforcement and prosecution actions have helped to nip the problem in the bud and prevent cases of non-payment of wages from developing into claims to the Fund. In 2004, 504 summonses for wage offences were convicted, representing an increase of 13.3% over the previous year.

(f) Formation of an inter-departmental Task Force to tackle abuse

An inter-departmental Task Force was set up in November 2002 to step up collaboration of various government departments in proactively pursuing and investigating possible abuse of the Fund. The Task Force comprises representatives of the LD, CCB, ORO and the Legal Aid Department.

The LD has referred 65 cases of suspected abuses to the Task Force since its formation. The CCB arrested some 50 persons in connection with seven of the cases. Among them, a director and an employee were convicted and both were jailed for a year. Of the remaining 58 cases, 45 are still under investigation by CCB and ORO, while 13 were closed due to lack of sufficient evidence. Of all the 65 suspected cases, 25 were from the catering sector.

(g) Enhanced publicity

The LD has stepped up publicity to remind employers that failure to pay wages on time is a serious offence. The LD also encourages employees to report non-payment of wages as well as suspected

fraudulent acts committed by employers in the course of the company's winding-up. To facilitate employees in making complaints on non-payment of wages, the LD has provided a telephone hotline 2815 2200.

Possible New Measures

8. Recent events surrounding the closure of a major restaurant has sparked considerable public concern over possible abuse of the Fund. There have been calls on the Administration to take further measures to protect the Fund against abuse, especially focusing on the catering industry which accounts for the largest share of the Fund's payment.

9. The LD has identified a number of preliminary ideas to further protect the Fund from abuse and ensure employees' rights to their statutory entitlements. A summary of these proposals is at Annex. Apart from the five immediate measures in the Annex which will be implemented by the LD in the short term, the proposed longer-term measures are complex and controversial. Most of these will entail legislative amendments and the full implications of these proposals have yet to be thoroughly examined.

10. In devising any possible new preventive measure, we must be careful not to fetter the local business environment and unduly add to the cost of doing business. We need to strike a right balance.

Economic Development and Labour Bureau
Labour Department
April 2005

**Possible Measures to Further Prevent Abuse
of the Protection of Wages on Insolvency Fund**

**A. Immediate measures (to be adopted by the Labour Department (LD)
in the short term)**

**1. Recruiting retired police officers with criminal investigation
experience to reinforce LD's capacity in investigation and
intelligence gathering**

The LD will recruit a number of retired police officers with criminal investigation experience as soon as possible to assist in intelligence gathering and in identifying and collecting evidence on suspected fraud and deception cases.

**2. Strengthening LD's early warning system on non-payment of
wages in the catering industry**

The LD will step up publicity to remind employees of the importance of taking prompt action to protect their interest if their employers fail to pay them wages. The LD will also encourage trade unions to report cases of non-payment of wages without delay so that the problem can be solved as soon as possible.

3. Stepping up enforcement against restaurants

The LD has launched targeted inspection campaigns to the catering industry to detect wage offences under the Employment Ordinance and distribute advisory leaflets to employees. Labour inspectors are currently conducting a territory-wide campaign to catering establishments. We will continue to rigorously prosecute employers where there is sufficient evidence.

4. Helping individual restaurants to improve their management

At the enterprise level, the LD will proactively approach restaurants with repeated record of labour disputes (i.e. three claim cases lodged within six months) with a view to assisting them to improve their management practice.

5. Mobilising the catering industry in adopting good management practices

The LD will mobilise the catering industry in adopting good management practices. To this end, we will meet the various trade organizations shortly to discuss how best the LD and the industry can join hands to take this forward.

B. Longer-term measures

6. Mandatory requirement for all restaurant proprietors to provide bank guarantees for the statutory entitlements of employees

The catering industry has, over the past decade, consistently accounted for the major share of applications to the Fund. Of the 13 631 applications in 2004, 5 333 or 39% came from the industry. For the first quarter of 2005, of the total number of 2 930 applications received, 1 597 (or 55% of the total) came from the industry, as compared with 1 286 (or 34%) in the same period last year. This represented an increase of 24%. The industry also accounted for \$116 million or 30% of the \$382 million payment from the Fund in 2004. There is therefore a case to focus on the catering industry.

Under the proposal, before a restaurant obtains or renews a licence, the operating company or directors must present a reasonable bank guarantee to guard against defaults in payment if the restaurant fails to pay its employees on closure. The Fund Board could be made the beneficiary of the bank guarantee. As at 31 March 2005, over 10 000 licences for restaurants were issued.

7. Mandatory requirement for restaurant proprietors who had been involved in cases requiring payment from the Fund to provide bank guarantees for the statutory entitlements of employees

This is an alternative to proposal (6) above and serves essentially as a risk management measure. If a director of a restaurant has been involved in insolvency cases which required payment from the Fund within a certain period (say 5 years), the operating company or its directors must, as a pre-condition for licensing, present a bank guarantee. In effect, the group of restaurant proprietors targeted would be far less. For example, in 2004 only 297 catering establishments were involved in the applications to the Fund.

This measure, if adopted, would largely address the recommendation of the Fund Board that restaurant licences should only be issued after confirming that the employers have not been involved in cases which required payments from the Fund.

8. Scaling the levy rates of Business Registration Certificates by industries

Employers in industries that account for significant portions of claims to the Fund will be required to pay a higher Business Registration Certificate levy. This would be more equitable as Fund-prone industries would share out the larger amount of payments from the Fund to applicants. However, a levy system with different levy rates imposed on different industries would be costly to administer and difficult to police.

9. Separate funds for certain industries

This is similar to proposal (8) above except that employers in the selected industries would support their own funds on a self-sufficient basis. Employers in industries with a large number of applications to the Fund may have to pay a higher levy. However, with this proposal employers would not be able to enjoy the pool effect of sharing payments among all industries under the present system.

10. Requiring employers to recognise the contingent liability for severance payment

It is a standard accounting practice that an enterprise has to recognise:

- (a) an expense in the Profit and Loss Account when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits; and
- (b) a liability in the Balance Sheet (as an accrued expense) when an employee has provided service in exchange for employee benefits to be paid in the future (e.g. severance payment).

This requirement facilitates relevant parties including shareholders, creditors and lending institutions to recognise the contingent liability of the enterprise in terms of severance payment, and reduces the opportunity for misappropriation of the resources of the enterprise.

However, there is no compulsory requirement on the part of enterprises to make at least some provisions to conserve internal resources to meet this liability. Some enterprises provide for their contingent liability in respect of Long Service Payment (LSP) which is payable to employees on reaching their retirement age, while some others do not provide for their employees' entitlement to SP/LSP.

We will consult the accounting profession on how best to promote and ensure compliance in this respect.

11. Introducing the Companies (Corporate Rescue) Bill

Legislative proposals on corporate rescue procedures and insolvent trading were introduced twice into the Legislative Council (LegCo) in recent years, first in 2000 and then in 2001. Regarding the former, the proposals were included as part of an amendment bill to the Companies Ordinance, but were subsequently taken out after the relevant Bills Committee noted the complexity of the issues involved. As for the latter, the proposals were set out in a standalone Companies (Corporate Rescue) Bill. The Bill aims to provide for a corporate rescue procedure for a company in financial difficulty which the directors believe can be overcome provided they are given time to pay creditors claims and, in relation to the introduction of the corporate rescue procedure, to make directors and senior management personally liable for the debts of their company which continued to trade while insolvent and where there was no reasonable prospect of trading out of the financial difficulties (i.e. insolvent trading). Thus, on the one hand the Bill may provide an alternative for a company to avoid winding up, and on the other hand, it may help deter the directors and senior management from acting irresponsibly while the company is insolvent.

During the scrutiny of the Bill by the LegCo Bills Committee, some Members and stakeholders had expressed concern about matters such as the trust account arrangement in respect of employees' entitlements and the possible impact of insolvent trading provisions on the business sector. In response to such concern, the Administration had conducted further study and consultation with relevant bodies such as the Labour Advisory Board. Notwithstanding the efforts made, the Bill was not enacted during the last term of LegCo. As reported to the Bills Committee in June 2004, the Administration would review, in the light of the developments in other jurisdictions on the corporate rescue and insolvent trading matters, the need for such legislative proposals in Hong Kong and, if so, how best they should be tackled.

The Administration is now collating the relevant information on developments in other jurisdictions. Given the complexity of the proposals involved, for example, how to strike a balance among the interests of various parties such as investors, employees and other creditors, as well as the significant implications of the proposals on the business sector (in particular the idea of introducing insolvent trading provisions), the Administration would need to consider the proposals in detail, and engage the relevant stakeholders in the process as necessary.

In any case, the Administration would continue to explore the feasibility of introducing a new Companies (Corporate Rescue) Bill into LegCo as a longer term option. Having said this, it is relevant to note that there is a view that while the relevant corporate rescue and insolvent trading proposals may help relieve the number of claims against the Fund, their impact in practice may be very limited and be subject to factors such as the cost of the corporate rescue procedures vis-à-vis liquidation, and whether or not a company in financial difficulties can or should be saved.

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