Australian Corporate Insolvency: Problems and Solutions

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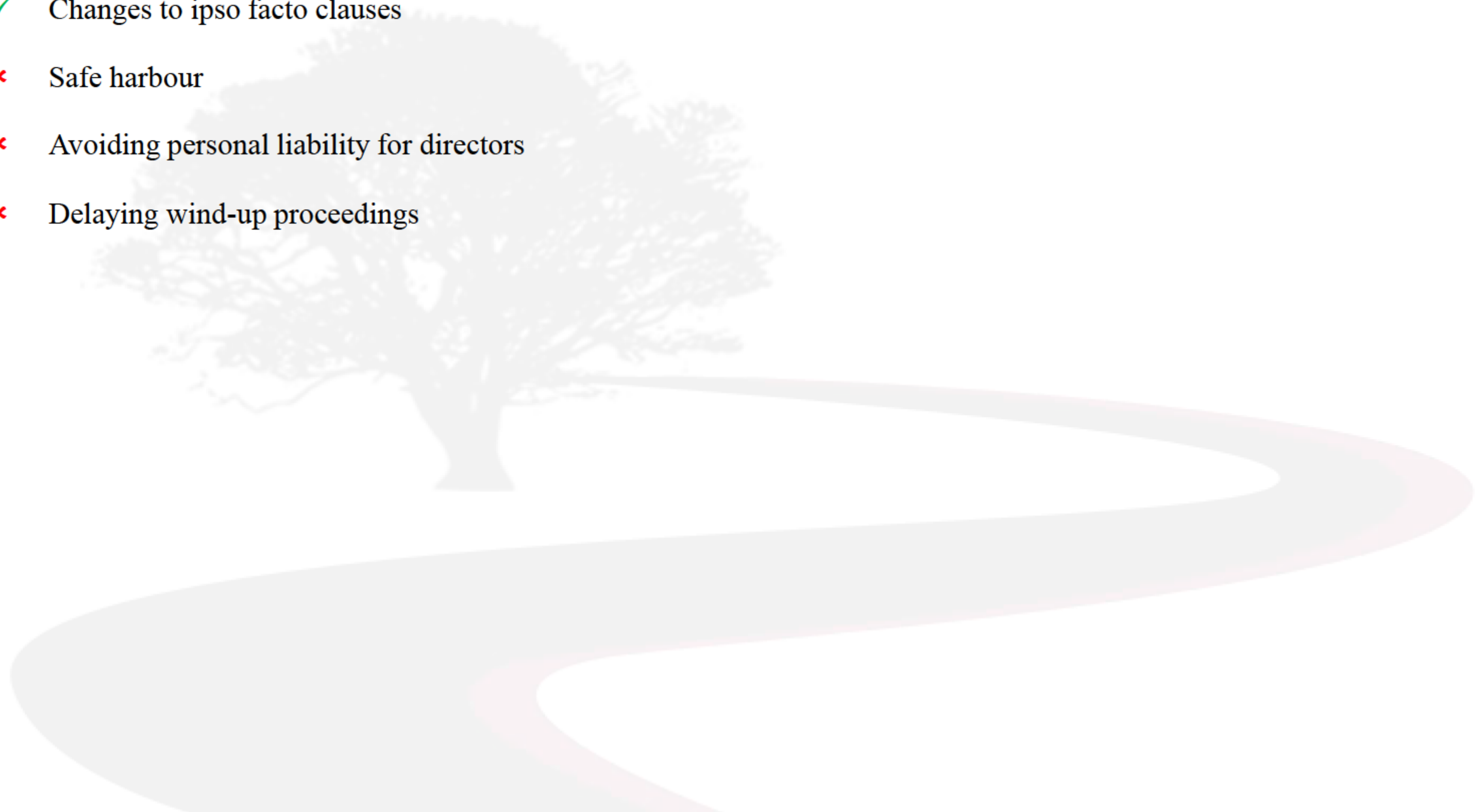
Submission Summary

- Problems cited with the existing regime – what are we trying to solve?
- Philosophical starting point for reform – what are the important principles any reform must meet?
- Should failing businesses be saved – what are the costs and consequences for saving unprofitable businesses?
- Background on SME and large business failures – what needs to be understood before considering reforms?
- Ipso Facto reform – a good reform that will assist some sustainable but over-indebted businesses to survive
- Safe harbour reform – an unnecessary and dangerous reform that will see advisors enriched at creditor's expense
- Overdue debts – what can be done to assist businesses to be paid in a reasonable time and crack down on phoenixing?
- ASIC's role – meaningful reform to insolvency requires ASIC to step-up enforcement and education initiatives
- The ATO's role – by compromising debts the ATO is subsidising "losers" that should be recapitalised or closed down
- Conclusions

Position on Recent Changes

- ✓ Changes to ipso facto clauses
- ✗ Safe harbour
- ✗ Avoiding personal liability for directors
- ✗ Delaying wind-up proceedings



Problems Cited with Insolvency

- Ipso Facto: Contracts that could remain in order are often terminated, destroying business value
- Director's Duties: Fear of being held personally liable, although prosecutions are extremely rare
- Overdue Debts: Some businesses are continually late in paying their suppliers with enforcement expensive and slow
- Phoenix Companies: Theft from employees, taxpayers and other businesses goes unpunished
- Prepack Insolvency: Why is it so hard and is value being lost?
- Cost of Administration: If the business wasn't already dead does the cost of administration kill it?
- Safe Harbour: Can more businesses be saved? Will losses to creditors increase as a result?
- Director Training: Are directors adequately trained to assess solvency?

Philosophical Starting Point for Reform

- More risk taking is desirable, but risk must be taken with capital that is paid to take risk.
- Financiers and equity investors are in the business of taking risk and pricing risk.
- Employees, the ATO and trade creditors cannot be expected to monitor risk and price for it, or be expected to take expensive and complicated legal action to see that their debts are paid.
- Directors and senior management are best placed to monitor and manage the risk and solvency of a company. They are typically remunerated for this work and must bear responsibility for inappropriate business failure.
- Most businesses exit well (sale or wind-down), but a few fail badly and spread their losses through the economy.
- When insolvency occurs the legally recognised order of priority must be honoured.
- In insolvent and borderline companies the recovery of creditor's funds takes priority over shareholder interests.

Should Failing Businesses be Saved?

- Most sectors in an economy allow for new entrants/competition. The process of competition strengthens an economy in the long term as successful firms flourish by offering their customers a better value proposition. As a result, their customers are better off and use their improved position to strengthen their business or to spend on other things.
- A lack of competition causes economies to stagnate and become inefficient, with their exports lower quality and higher priced relative to other countries (e.g. Communist Eastern Europe).
- Successful businesses typically have better decision making, lower costs and are better capitalised. It is inevitable that some businesses will succeed and others will fail.
- When businesses fail the most immediate and obvious outcome is a reduction in employment and the demand for goods and services by the failed firm. However, other firms have or will take their place creating higher demand for employees, goods and services. This replacement economic activity is almost never as visible as the failed company.
- In the long term, the replacement of poorly performing businesses with better performing businesses helps an economy to thrive and increases the opportunities for income and wealth for all.
- Saving failing businesses comes with both short and long term costs (e.g. greater inefficiency, moral hazard) and is typically delaying inevitable change.

The Ansett Case Study

- In 2001 Australians had the choice of three mainline carriers, Ansett, Qantas and Virgin. Compass had tried twice in the 1990's to establish itself as a third airline but failed both times.
- The introduction of Virgin in 2000 brought substantial price competition. Virgin had a much lower cost business model than Ansett and Qantas. Ansett's high cost business model (particularly aircraft and staff costs) wasn't matched by high levels of service. As a result, it lost customers to Virgin and was substantially unprofitable.
- As a result of the losses Ansett was dependent upon its parent company, Air New Zealand for financial support. When Air New Zealand needed financial support from the New Zealand government it chose to withdraw its support of Ansett. Insolvency quickly followed in September 2001.
- Despite substantial effort, Ansett was not able to be quickly turned around. Potential buyers sought government guarantees as they believed there was a high risk that Ansett would remain unprofitable.
- Whilst the loss of jobs when Ansett failed was well publicised, the employment generated by its competitors before and after Ansett failed went largely unnoticed.
- The substantially lower cost of air travel available pre-Covid began with the new entrants that ultimately killed off Ansett. Had the duopoly of Ansett and Qantas remained, the cost of passenger air travel and cargo would be higher.

The Virgin Australia Case Study

- For many years prior to its insolvency in 2020, Virgin Australia was unable to make a profit. It had a much higher cost base than Jetstar, but a lower quality of service than Qantas. The business had too many planes, too many staff and too little equity capital, with its credit rating indicating it was a high risk borrower.
- Whilst the Covid lockdowns brought about a rapid descent into insolvency, the weak financial state meant an insolvency was likely to occur whenever a decent downturn next occurred.
- As the business teetered towards insolvency, unions and some members of Federal Parliament called for a government bailout in excess of $1 billion. Fortunately, these calls were rejected and taxpayers were saved from enormous losses.
- Virgin Australia needed the legal framework of insolvency to reduce its fleet, staff numbers and debt levels. With these corrected, Virgin Australia has emerged as a profitable, viable and competitive business.
- Australian aviation continues to attract new competitors with Rex expanding to capital city routes and Bonza looking to commence flying shortly. The addition of new competitors is likely to bring down prices but comes with the risk that some airlines may not prove to be viable. As the examples of Ansett and Virgin Australia have shown, this is a normal part of operating in a competitive industry.

Small and Medium Business Failures

- The primary creditors of SME businesses are other businesses, employees and the ATO. These creditors are not in the business of assessing risk and charging a margin for accepting that risk. There is a reasonable expectation that directors are the experts on the financial health of their companies and are best positioned to recapitalise or close their businesses if solvency is doubtful.
- The primary problem with SME failures is that businesses are waiting far too long to get advice and are trading insolvent for months or years before voluntary administrators are appointed. In recent ASIC data 78.5% of insolvencies had alleged misconduct with 4,135 cases having documentary evidence to support the allegations. Despite this, insolvent trading prosecutions are almost unheard of.
- It is common for companies to continue trading whilst a substantial backlog of employee, trade creditor and ATO claims grow. Often, it is only when a wind-up action is commenced that directors consider their duties to creditors.
- Whilst insolvent trading is sometimes due to a lack of legal and financial expertise, phoenix activity is rife. A 2012 report by PWC estimated losses from phoenix activity were $1.78 – $3.19 billion per annum. This is large scale theft and must be treated as such.
- Two responses are needed to these issues, education and deterrents/enforcement. ASIC is best placed to administer both of these. Potential responses are covered later in this submission.

Large Business Failures

- Unlike SME failures, large businesses have significant access to legal and accounting expertise, both inside their firms and from professional advisory firms. Directors of large businesses are typically well aware of their responsibilities.
- Despite the lack of prosecutions, directors frequently mention the fear of insolvent trading as something that holds back risk taking. There is a belief amongst some that their own assets could be lost even if they act appropriately.
- It is a commonly raised concern that insolvency occurs too early as a result of such fears. When pressed for an example of this actually occurring, the only case of merit is Henry Walker Eltin (2005), where creditors were repaid in full and shareholders received $0.17 per share.
- Directors who are concerned about losing their assets from insolvent trading claims have numerous avenues to protect themselves. First, they can get legal and financial advice to ensure that their companies are not trading insolvent. Second, they can resign from the board should they be concerned about its financial position. Third, they can raise additional capital for the business to underpin its solvency. Fourth, they can mitigate their personal risk via professional services insurance and using trusts to hold their personal assets.
- Claims that Australia's insolvency system is draconian should be dismissed. There is virtually no evidence that insolvency is happening too early or that directors who perform their duties adequately are at risk.

Ipso Facto

- The recent changes to ipso facto clauses are common sense and will do a great deal to allow some sustainable but over-indebted companies to survive.
- Suppliers and customers should be entitled to have assurance that they will receive future payment or service provision as per their contract. This may require an administrator to pay for goods or services on delivery, provide a bank guarantee or deposit, pledge assets or other common methods of providing reassurance within reasonable limits.
- Ipso facto clauses should not apply to debt providers. Whilst their position can be stayed during insolvency, they should not be forced to provide additional credit (e.g. overdraft) once an event of default or insolvency has occurred.

Safe Harbour

- As discussed in previous slides, the issues cited as creating a need for safe harbour provisions are vastly exaggerated. Safe harbour provisions are unnecessary and dangerous.
- Safe harbour provisions do not do anything that a voluntary administrator cannot already do to see a sustainable business survive. However, by leaving management and directors in control, repayment of creditors is likely to worsen.
- Safe harbour provisions enrich advisors and impoverish creditors. Safe harbour provisions allow businesses that are or are likely to be insolvent to extend the period in which they can seek solutions.
- This will most likely be concessions from creditors, as customers are unlikely to accept price increases and few will consider investing debt or equity into such a high risk venture. Advisors can earn substantial fees assisting with this process. These fees are very likely to come from funds that would otherwise be used to repay creditors.
- For shareholders, safe harbour provisions create a "heads I win, tails you lose" outcome. Creditors funds are gambled on seeking longshot solutions. In almost all cases, no solutions are found and creditor losses increase. If shareholders and directors are unwilling to contribute additional funds to recapitalise the business, why should creditor funds be gambled?
- If there is a desire to see more businesses survive, the solution is for directors to be getting expert advice much earlier. By the time insolvency occurs or is being considered it is almost always too late for resuscitation measures to work.

Overdue Debts

- The failure of companies and governments to pay their debts on time is a substantial inhibitor to business activity. Slow payers are using their suppliers as an alternative to properly capitalising their business. Large businesses and governments that take months to pay legitimate invoices are abusing their size advantage. Delayed payments often cascade through industries, with companies struggling to pay their suppliers due to late payment by their customers.
- In some cases, creditors are turning to organised crime figures and bikie gangs to collect their debts. This is a particularly unsavoury outcome, largely due to the failure of businesses to pay debts and phoenix activities.
- Consideration should be given to introducing legislation that sets the standard payment term as 30 days, when no time period has been agreed in writing. Businesses would be free to contract other terms, when both parties consent.
- In the event a debt is outstanding 37 days after invoicing, the creditor would be entitled to formally serve a letter of demand. If the debtor fails to pay in full, or fails to contest the validity of the debt by an injunction within seven days the creditor would be entitled to seek a default judgement for an administrator to be appointed. Costs (both court and applicant costs) would be payable by the overdue debtor.
- The impact of this change would be that failing businesses would be dealt with much faster and phoenix activities would be substantially reduced. Whilst there would initially be a backlog of undercapitalised businesses failing after the legislation was introduced, in the medium and long term the economy would be far better off.

The Role of ASIC

- Consideration should be given to directors being required to attend training or complete an online test every three years. This would remind directors of their duties and their potential legal responsibility to make good losses if a company trades whilst insolvent.
- ASIC must take action to enforce insolvent trading laws. Prosecutions should be commenced on the most egregious cases with please explain letters sent whenever a liquidator concludes that insolvent trading was likely to have occurred. Failure to respond adequately to such a letter would see enforcement commenced.
- Directors who have presided over repeated company failures where insolvent trading has occurred should be banned for life from being a company director. Being a company director is a position of great responsibility. Those proven to be unable to handle those responsibilities should not be allowed to risk causing further losses to others.

The Role of the ATO

- The ATO is at the frontline in dealing with poorly managed and undercapitalised business. It is common that the ATO is the only creditor willing to expend the resources necessary to take legal action against recalcitrant debtors.
- Businesses collect GST and PAYG in the normal course and pay these amounts in arrears to the ATO. There is no reason that businesses should not be able to pay the ATO on time, as they have already received the GST or have held back the PAYG contribution from employee wages.
- The ATO process for dealing with recalcitrant payers is disorganised with substantial variation in treatment. As a result, some poorly managed and undercapitalised businesses rely on the ATO to fund their activities. The ATO is widely considered to the be the last creditor to be paid, with this position exploited by phoenix operators.
- By agreeing to debt compromises to "save" failing businesses the ATO is effectively "picking losers". The ATO is using the tax system to provide subsidies to poorly run businesses with all other taxpayers bearing the cost.
- The ATO should introduce a strict payment policy, that if any material part of a debt is outstanding more than 37 days after the due date, enforcement action is commenced. In the short term, this will see some undercapitalised and phoenix companies pushed into insolvency. In the long term, this will greatly reduce phoenix activities, speed up payments to employees/ATO/trade creditors and reduce subsidies given to failing businesses.

Other Needed Changes

- Pre-pack insolvency: Where a reasonable sale process has been run prior to insolvency and the majority of creditors likely to receive a recovery (by value) consent, pre-pack insolvencies should be encouraged. Pre-pack insolvencies allow over indebted but sustainable businesses to quickly transition to a more appropriate capital structure. Care must be taken that pre-packs are not used to phoenix business assets and that directors are still held accountable for losses inflicted on creditors.
- Cost of insolvency: The insolvency industry has acknowledged that there are a small number of bad apples. In the vast majority of cases these operators are known and ASIC has failed to act on the reports of misconduct made by peers and creditors. ASIC must take seriously its responsibilities in this area and investigate claims of abuses.

Conclusions

- The Australian business insolvency system is better than many other countries but is not without flaws.
- Most business exits are well managed (wound-down on their own or sold) but a small number fail badly injuring employees, trade creditors and taxpayers as a result of their poor planning and bad management.
- The primary issue in these cases is that directors are failing to get advice and are trading whilst insolvent. This can be due to ignorance (more training is required) or phoenix activity (lack of enforcement), which is rife. For both cases the inaction of ASIC needs to be addressed as a priority.
- The safe harbour reforms are unnecessary and dangerous. Large companies were already negotiating with their financiers prior to insolvency, often for months or years. Safe harbour will enrich advisors at the expense of creditors.
- The suspension of director's liabilities for insolvent trading and delaying statutory demands in 2020 were awful Federal Government policies that gave companies a green light to steal from employees, creditors and taxpayers.
- The process for enforcing overdue debts should be simplified and sped up. Businesses unable to pay their debts should be put into administration as soon as reasonably possible where their problems can be independently assessed.
- The ATO should be far more consistent and rigorous in enforcing debts. Compromising debts is "picking losers", with other taxpayers worse off. Forcing undercapitalised businesses to recapitalise or close down is the best outcome for Australian taxpayers, employees, trade creditors and the economy.