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Parliamentary Joint Committee on Corporations and Financial Services
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SUBMISSION TO THE PARLIAMENTARY INQUIRY OF THE JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES INTO CORPORATE INSOLVENCY IN AUSTRALIA

Introduction

1. This submission is concerned solely with matters arising under paragraphs 3(a), 3(b) and 7 of the Inquiry's Terms of Reference.

Paragraph 3(a) - Unfair Preference Claims

2. Laws providing for the recovery by a liquidator or bankruptcy trustee of payments made by an insolvent debtor in favour of an existing creditor during the period prior to the commencement of a liquidation (or, in the case of an individual, a bankruptcy) have formed part of the insolvency laws of this country for over 100 years. At the level of principle, these laws give effect to the "pari passu" rule, the objective of which is to ensure that the assets of an insolvent debtor are shared equally between creditors, and that no particular creditor obtains, either by chance or design, a payment which delivers a preference, priority or advantage over others with similar claims on the debtor's assets. At the level of principle, preference laws serve a worthy objective.
3. However, in practice, legal action by liquidators to recover unfair preferences rarely achieve, or even contribute to the achievement of, the

stated objective. There are a number of reasons for this, but by far the most significant of these, in the writer's experience in the conduct of 35 years of insolvency litigation, is the complexity of the process and it's costs.

4. As a result, unfair preference litigation, which is a common feature of many windings up, tends to serve only the interests of liquidators and their advisers, and nowadays, litigation funders, in recovering money from creditors (who almost always have already lost money as a result of their dealings with the insolvent debtor) which is then applied to pay liquidators fees and lawyers costs. That is not to suggest the payment of liquidator's fees and expenses (including legal costs) is inappropriate. However, processes which do not, in practical terms, contribute in a meaningful way to a better return to creditors in the winding up ought to be scrutinised notwithstanding their longevity and provenance.

5. Further, the arbitrary nature of such litigation, often depending, as it does, upon the appetite of the insolvency practitioner, and his or her advisors, to undertake speculative litigation and/or the availability of funding from commercial funders often results in unjustifiably unfair outcomes. Some creditors in some windings up get sued and others, in like circumstances, do not. If, as often happens, a claim is made for recovery of $20,000, $30,000 or even $40,000 the only sensible response for the creditor, regardless of the merits of their position, is to pay something to settle the case. The alternative, of resisting the claim and thus risk being dragged into litigation will almost always lead to costs which quickly exceed the amount in issue. If the result of this was that creditors generally were better off because the funds recovered were added to the distribution pool and produced a higher pro rata dividend for all then the process could be justified. But the sorry fact is that such recoveries are almost always fully consumed by the costs of the effort.

6. A submission was made to the ALRC General Insolvency Inquiry in 1989 by a sitting Federal Court judge that the preference laws should be removed entirely from the insolvency statutes. The suggestion made by the writer is not that such claims be removed entirely, but that they be confined so they apply only to payments made by an insolvent company to creditors who are related parties. The benefits of such would be:

i. unrelated third party creditors, who in the main have already suffered loss from their dealings with the insolvent debtor, will no longer be oppressed by the prospect of litigation which does not in any meaningful way advance the overall goal of the insolvency laws, namely to maximise the return to creditors from an insolvent estate; but

ii. preserving such in respect of transactions with related parties will discourage favourable treatment by directors of insolvent companies towards related parties and will allow for such transactions to be unwound if they have occurred. The merit of focussing on transactions which benefit related, as opposed to arms length, parties is already recognised in sections 588E(7), 588FE(4)(b) and 588FDA. Any argument that preference recovery litigation is “oppressive” is much less persuasive where the transaction is one between the insolvent company and a related entity. Such an approach would also promote another objective of the insolvency laws, including the anti-phoenixing regimes, of requiring directors and those in control of companies, which are actually insolvent, or facing insolvency, to deal fairly with company assets and preserve them for the benefit of all creditors.

7. Additionally, and as a means of reducing the costs of such litigation, the Act ought be amended so that the liquidator is not required, in a preference case against a related party, to show that the company was insolvent at the time of the transaction. It should be enough if the test in s588FA(1)(1)(b) is satisfied. A very substantial part of the costs and complexity of insolvency litigation accrues in the proof or denial of insolvency. Removing those costs will increase returns to creditors.

Paragraph 3(b) - The operation of insolvency laws vis-à-vis trading trusts and corporate trustees

8. The proliferation of trading trusts controlled by corporate trustees as a means by which businesses are conducted is well-known. There is nothing inherently inappropriate with that mode of business operation. However, unfairness can arise where the insolvency laws operate differently as

between non-trustee debtors (such as ordinary trading companies) and debtors whose business has been conducted on trust. Employees and suppliers can be entirely unaware of the fact that a particular employer or customer is conducting business as a trustee and will, in any event, often be entirely unaware of the potential significance of that fact should the employer or customer become insolvent and enter an insolvency administration. There is no acceptable rationale for any difference in treatment between those who are creditors of a failed business conducted as trustee and those dealing with debtors who are conducting business in their own right.

9. The law regarding the distribution of the debtor's assets should ensure that different outcomes for creditors do not depend upon the capacity in which the insolvent debtor holds its assets or runs it's business. Those are matters that do not alter the fundamental nature of the original dealings between the creditor and the company and there is no reason they ought to alter the outcome in an insolvency scenario.

Paragraph 7 – "Any related corporate insolvency matters"

10. Two specific suggestions are made in relation to this aspect of the Inquiry:

    i. The practice whereby a failing or failed company is able to alter its name and replace it with its ACN number (so that, for example, it operates thereafter as 123 456 789 Pty Ltd) is often connected with unlawful phoenix activity. The practice should be outlawed, or at least regulated. If the change of name is undertaken by an insolvency practitioner under a formal appointment, such as a liquidation or receivership, then the practice can serve the goal of maximising the possibility of "selling" the debtor's business, including it's goodwill, and thereby improving the prospects of a return to creditors. However, there is very little advantage to creditors of an insolvent company which is still under the control of it's director or directors for such a change to be carried out. In most cases it facilitates a transfer of business or other assets to third parties who are often related to those

in charge of the failed operation. Provisions should be considered which would make it an offence for a director to cause such a change to occur if it is proven that, at the time of the change, the company was, or was about to become, insolvent. Another possibility is to create, for the purposes of s588E of the *Corporations Act*, a presumption of insolvency if such a name change occurred in a specified period prior to the commencement of a formal winding up;

ii. S579E of the *Corporations Act* allows for the making of "pooling orders" in the winding up of a group of companies. Where one or more related companies are being wound up as a result of a collapse of a single business venture, the ability of a liquidator to "pool" the assets and liabilities of the many companies into a single estate is plainly beneficial. It produces a simplified, less expensive and, ideally, more efficient winding up process. However, the pre-conditions for the making of a pooling order, as set out in s579E(1)(b) of the Act, can mean that access to the "pooling" regime is not always available in such cases. In particular, the requirement that the liquidator, seeking a pooling order, be able to show that one or more of the companies within the group *still owns property* which was used in the original scheme or enterprise can mean access to that regime may not be available if, as is often the case, all of the assets and property that had been held as part of the joint enterprise has been lost, or transferred, prior to the initiation of the windings up. The proliferation of liquidations involving numerous companies, which may not be formally related by common directors for instance, but which conducted related businesses, justifies a change to the current law making it a simpler process for a liquidator to access the benefits that can be derived from the pooling regime. The suggestion is that the sole requirement be that it be shown that at some time in the past those companies conducted *a joint scheme, business or undertaking.*

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