BlueRock

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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee Secretary

SUBMISSIONS TO THE PARLIAMENTARY INQUIRY INTO THE EFFECTIVENESS OF AUSTRALIA'S CORPORATE INSOLVENCY LAWS

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EXECUTIVE SUMMARY

"An ounce of prevention is worth a pound of cure." We ask the Committee to bear these words in mind when considering our submissions below. Australia's recent law reforms in the corporate insolvency space have only sought to treat the symptoms of an ailing industry. It is long past time that we seek a cure.

The result of these decades of piecemeal amendment to Australia's corporate insolvency regime is that our laws are not "fit-for-purpose" particularly when it comes to smaller businesses.

The problems with our corporate insolvency laws can be generally distilled down into four underlying issues:

1. **the inaccessibility and complexity of the regime**. Insolvency laws are split across several different Acts, Schedules, Regulations and Rules and require a high level of expertise to access, let alone understand. There is also limited support or education available for company directors, leading to an inefficient use of resources;

2. **undue burden of regulatory compliance on insolvency practitioners.** Regulatory compliance is often responsible for preventing or reducing any return to unsecured creditors, aggravated by ASIC's Industry Funding Model;

3. **limited access to simplified, cheaper insolvency administrations**. Small businesses and SMEs often resist early restructuring due to the high costs or limiting criteria for access to Small Business Restructuring (**SBR**) or simplified liquidation, which perversely incentivises trading insolvent and phoenix activity; and

4. **failure to codify or consider key legal concepts.** The mechanism for dealing with the insolvency of corporate trustees is expensive and inefficient, and core concepts of the voidable transactions regime are not codified at all, leading again to lower returns to unsecured creditors through unnecessary legal costs.

Our submissions will focus mostly on Terms of Reference 2, 3, 4 and 5, as we consider these terms of reference to be more relevant to our abovementioned underlying issues.

THE OPERATION OF THE EXISTING LEGISLATION, COMMON LAW, AND REGULATORY ARRANGEMENTS:

Reform generally

Australia's corporate insolvency regime is unduly complex. For instance, the *Corporations Act 2001* (Cth) ("Act") contains approximately 4,000 pages of legislation and is difficult to navigate by virtue of the fact that the relevant sections of the Act are dispersed throughout and there are complex uses of defined terms throughout. There are multiple regulations, practice schedules and delegated instruments which have been added onto the Act over time, as *ad hoc* amendments. The introduction of the *Personal Property Securities Act 2009* (Cth) further complicates matters with respect to secured creditors, by introducing what might be described as a "Kafkaesque" system for registering security interests over assets. The net result of this complexity is that we are left with a corporate insolvency regime that is opaque and difficult to understand even for experts in the field. A possible solution is to draft a "Corporate Insolvency Act" that condenses and simplifies the legislation. This would reduce wasted legal costs associated with the often Herculean task of gleaning an answer to a straightforward question relating to insolvency laws in Australia.

Small Business Restructuring and Anti-Phoenixing reforms

When the recent reforms creating the SBR regime were passed, they were heavily criticised by the Australian Restructuring, Insolvency and Turnaround Association ("ARITA"), the peak industry body for insolvency in Australia. In practice, however, the SBR administration has been quite successful by those who have been able to take advantage of it. The crucial feature that this type of administration provides is an alternative to simply waiting for a creditor (such as the Australian Tax Office) to spend the money to commence a winding up application against the company, or to attempt to phoenix. Smaller businesses and their owners generally do not have the available funds to pay for voluntary administration. The lack of options perversely incentivises companies to attempt to trade out longer than they otherwise should have or attempt to phoenix the company and escape their liabilities. With a cheap, debtor-in-possession administration available, early intervention is possible. Even if the business cannot be worked out, the point at which they are liquidated is earlier than it otherwise would have been, reducing the risk to their creditors associated with trading insolvent.

Simplified liquidation

Conceptually, one way to look at SBR and simplified liquidation would be as the small business equivalent to voluntary administration and liquidation, respectively. Unfortunately, the simplified liquidation reform has been largely unsuccessful to date. The cost of running these liquidations is effectively the same as a standard liquidation, as the process is burdened with undue regulatory compliance. This has disincentivised insolvency practitioners from using this method, as it provides no advantage to creditors. Simply put, we submit that this concept should be pursued, but it must be made more cost effective.

Personal Property Security Register ("PPSR")

Conceptually, having a unified concept of security interests with priority rules is beneficial, however, Australia takes the concept further and used the PPSR as a way to validate security interests. Because of this issue and others there have been some fairly significant problems with the PPSR to date. For example, the rules for when a perfected security interest vests due to an insolvency practitioner being appointed over the grantor are contained in the Act, and the same rules for when a security interest is unperfected are contained within the PPSA. This goes to the aforementioned issue of relevant legislation being inaccessible to interested parties.

Furthermore, and perhaps more critically, using the PPSR as a means to validate security interests unfairly favours general security ("GSA") holders over specific security holders. The parties that tend to make mistakes or fail to register their interests are overwhelmingly smaller parties with specific securities. Secured parties using retention of title ("ROT**"**) clauses provide the best example of the issue: Security interests are perfected by possession, control or registration. Necessarily, ROT holders do not tend to have possession or control over their collateral, so registration is the only way to perfect their interest. The register is quite unforgiving with respect to incorrect registrations, so small mistakes by suppliers can have devastating consequences when a customer goes into administration or liquidation, losing their secured status to larger secured parties that hold GSAs, and left to prove with unsecured creditors.

The idea that a register is required to validate an interest is outdated. It is common knowledge in most industries that possession of an asset does not imply ownership, and further, the register cannot be relied on to give an accurate picture of potential security interests against a company at any time, as a prior interest could be registered moments after you completed your search. In the circumstances, it would be appropriate to relax the registration rules insofar as they apply to ROT holders, in order to rebalance the interests of specific security holders. The New Zealand PPSR regime can be looked to for guidance on this point.

POTENTIAL AREAS FOR REFORM:

Unfair preferences and voidable transactions generally

Unfair preference claims are routinely criticised as being unfair themselves, with some groups going so far as to advocate for their abolition, but our position is that these claims go to the very heart of insolvency law and are a critical function in ensuring proportionate distributions to creditors.

To illustrate the importance of these claims, consider a landscape without them. Directors of companies approaching insolvency would then hold all of the power when considering which creditors will get paid and which creditors will be left with nothing, including secured creditors. This mechanism less obviously discourages phoenixing activity, by removing the ability for a director to simply pay important trade creditors and then maintain those relationships in the new entity.

We submit that the unfair preference scheme, and indeed the voidable transaction scheme more generally is in need of minor reform, though more due to a failure by Parliament to codify important concepts into law.

In the recent case of *Badenoch Integrated Logging Pty Ltd v Bryant*[1] (currently awaiting a decision from a High Court appeal), the industry was thrown into disarray by the Federal Court over the possible abolishment of the 'peak indebtedness rule' which allows a liquidator to choose the highest point of indebtedness during the relation back period when assessing an unfair preference claim in the context of a continuing business relationship. The removal of this rule would be extremely undesirable to the industry, as the trade creditors with those continuing business relationships are exactly the type of creditors that an unscrupulous director would choose to preference with a view to maintaining a business relationship subsequent to a liquidation. Regardless of the way the High Court decides the appeal, this rule should be codified.

Likewise, in the recent decision of *Morton as Liquidator of MJ Woodman Electrical Contractors Pty Ltd v Metal Manufacturers Pty Limited*[2], the Court confirmed section 553C(1) of the Act is not available to a creditor with respect to unfair preference claims. Given the underlying reasoning in this case was that there is no mutuality between a debt owing to the creditor by the company in liquidation, and the liquidator's disgorgement action, this reasoning should be applied across all voidable transaction claims and codified. Further, allowing a creditor to use a set-off argument undermines the *pari passu* distribution principle that underpins insolvency law, as by definition it prioritises those creditors above all other creditors, and even the liquidators to the extent of the set-off. This also violates the universal distributing principles.

Trusts

The way in which trading trusts are dealt with under our current insolvency laws is inefficient. Chiefly, our main concern is with auto-ejection clauses for insolvent corporate trustees in many trust deeds. When a corporate trustee suffers an insolvency event, these clauses can eject the trustee, leaving them a bare trustee with limited or no power to deal with trust property. This of course leaves the appointed insolvency practitioner in an unenviable position, requiring them to make applications to the Court to be appointed receiver and manager over trust assets in order to deal with them in any meaningful way, and often further applications for orders for the distribution of trust assets. These applications can incur in the tens of thousands of dollars' worth of legal costs and remuneration for the liquidator, which obviously reduces returns to creditors.

A relatively simple solution is possible here, which is to expand the existing *ipso facto* clause regime in the *Corporations Act* to prohibit these clauses in this context. Alternatively, and perhaps more wisely, Parliament could legislate that when an insolvency practitioner is appointed over a trustee company, they will have all the necessary powers to deal with the trust assets as they require, and additionally prevent enforcement of any clauses in the trust deed that provide for the removal of the insolvency practitioner as trustee or seek to limit their powers in any way. There is no reason that these administrations should not be able to proceed like a liquidation in the ordinary course, albeit considering the differences between company property and trust property, and whether creditors are properly creditors of the company itself or trust creditors.

[1] [2021] FCAFC 64
[2] [2021] FCAFC 228

ACCESS TO CORPORATE TURNAROUND CAPABILITIES:

As previously stated, small businesses have limited access to turnaround capabilities largely due to the expenses involved, and from lack of education or awareness.

This limited access or awareness incentivises directors to wait for the ATO to commence windup actions, or to consider phoenixing, as they do not generally have the funds to access necessary advice or fund a DOCA, and the SBR scheme is difficult to access. The net effect is we have many smaller businesses continuing to trade and racking up debts until the ATO commences winding up proceedings. The public funds that go into such proceedings could be better spent by early intervention and advice. We recommend that a fund be set up for this purpose, to offer businesses undergoing financial hardship to access pre-insolvency advice.

Additionally, the SBR scheme is an excellent initiative as discussed, however it should be expanded. A restructuring plan is only available to companies with liabilities of one million dollars or less, which is unduly limiting, as those liabilities can include future rents. We would recommend at least doubling this limit to allow more businesses to take advantage of the scheme and reduce overall inefficiencies in the system.

Another important consideration in this context is that there is limited education and awareness around these processes for directors of SMEs. Indeed, anyone can become a director without gaining any insight into their obligations. Bartenders have more hoops to jump through before they are legally entitled to serve someone a beer. A potential solution to this is to have ASIC or the relevant body from time to time administer a simple online course with a test component, similar to a driver's licence or Responsible Service of Alcohol test, before new directors are granted a Director Identification Number. At the very least, this should include education materials about insolvency and access to turnaround schemes.

THE ROLE, REMUNERATION, FINANCIAL VIABILITY, AND CONDUCT OF CORPORATE INSOLVENCY PRACTITIONERS:

Any suggestion that the remuneration of insolvency practitioners is excessive and needs to be capped should be dismissed. The essential work required to be undertaken is extremely specialised and difficult, and insolvency practitioners are already required by law to do significant work for ASIC for free. ARITA conservatively estimates the value of that work to be in the range of $100 million per year, or about $150,000 per liquidator per year. This work largely includes investigating the history of a company and its directors and preparing reports on misconduct to ASIC. This sort of regulatory compliance greatly contributes to upward pressure on the fees charged by insolvency practitioners, for work which is overwhelmingly of no value to the regulator.

ASIC's own statistics on enforcement activities from 1 January 2022 to 30 June 2022 show that only 27 individuals or companies were even charged with a criminal offence, and only 7 cases were commenced for civil penalties.[3] Over the same period, 2,643 companies went into external administration in Australia.[4] To put that into perspective, the investigations that ASIC requires

[3] ASIC, 'Summary of enforcement outcomes: January to June 2022', https://asic.gov.au/about-asic/asic-investigations-and-enforcement/asic-enforcement-outcomes/summary-of-enforcement-outcomes-january-to-june-2022/

[4] ASIC, 'Insolvency statistics – Series 1 Companies entering external administration and controller appointments', https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics-up-to-31-july-2022/insolvency-statistics-series-1-companies-entering-external-administration-and-controller-appointments/

insolvency practitioners to undertake (whether they have funding or not) result in criminal charges being laid only 0.01% of the time.

Rather than requiring insolvency practitioners to undertake these expensive investigations of limited value and report the same to ASIC, we recommend that the insolvency practitioner use their own discretion to undertake investigations and make reports in circumstances where they consider it likely that serious misconduct has occurred.

Additionally, liquidators are required to contribute to ASIC's Industry Funding Model, which we consider inappropriate, given the current state of affairs that has insolvency practitioners engaging in unfunded investigations by mandate, that only result in ASIC taking action in 0.01% of cases.

Significant improvements in returns to creditors can be made in this area by removing mandated regulatory compliance and giving the insolvency practitioner more discretion to engage in these investigations and reports when they are on notice of serious misconduct, rather than the inflexible and wasteful approach currently adopted by ASIC.

Finally, we consider that having one regulator for personal insolvency and one for corporate to be inefficient, particularly given 95% of trustees in bankruptcy are registered liquidators. The Committee should consider handing over the regulation of corporate insolvency to an AFSA-type body.

RECOMMENDATIONS:

The appropriate outcome of this inquiry is that the Committee recommend that Australia's corporate insolvency laws undergo a holistic reform process that considers:

1. Drafting a "Corporate Insolvency Act", condensing insolvency legislation to a single Act to the extent possible

2. Codifying the "peak indebtedness rule"

3. Codifying the unavailability of a set-off defence to a voidable transaction claim

4. Legislating that *ipso facto* clauses for automatic ejection of a Trustee are unenforceable, or alternatively, legislate that the appointment of an insolvency practitioner to a corporate trustee automatically grants them the powers over trust assets such that the insolvency process can be run as if it were a regular corporate insolvency

5. Reforming the PPSR in line with New Zealand's regime

6. Creating a fund for early appointment of insolvency practitioners over small businesses eligible for small business restructuring

7. Creating a tiered system of requirements for regulatory compliance, tied to the size of the insolvency administration

8. Expanding the eligibility criteria for "small business restructuring"

9. Creating a licencing system for new company directors, distinguishable from the current requirement of needing to register for Australian Director ID, requiring successful passing of a basic test in order to get a DIN

10. Making ASIC's mandatory investigation and reporting requirements discretionary

11. Creating an AFSA-type body to regulate the insolvency industry generally, and abolishing ASIC's Industry Funding Model requirements for insolvency practitioners.

Please do not hesitate to contact the author should you have any questions regarding these submissions or would like to discuss the matters raised above.

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