More than just Insolvency

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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,

SUBMISSION TO THE PARLIAMENTARY INQUIRY INTO CORPORATE INSOLVENCY IN AUSTRALIA

We refer to the Inquiry into the effectiveness of Australia's corporate insolvency laws in protecting and maximising value for the benefit of all interested parties as commenced by the Parliamentary Joint Committee on Corporations and Financial Services on 28 September 2022 ("Inquiry").

We also refer to the terms of reference in relation to the Inquiry as agreed on 28 September 2022.

We are of the view that the terms of reference are unnecessarily narrow by failing to also address personal insolvency matters. The Australian Law Reform Commission Report No. 45 ("Harmer Report") was tabled on 13 December 1988) and since that date, there has not been a complete review of Australia's insolvency laws despite a considerable shift in the way we live and work.

The Corporations Act 2001 (Cth) ("the Act") as it currently exists is unnecessarily cumbersome and complex as a result of regular tweaking without a complete review of the Act as it applies to insolvency. It is not uncommon when dealing with the Act to review each of its 5 different components:

- The Act
- The Regulations
- The Insolvency Practice Rules
- The Insolvency Practice Schedule ("IPS")
- The Bankruptcy Act 1966 (Cth) ("Bankruptcy Act")

An example of this is to identify the definition of a "related entity" for a proposal vote. This requires a reference to s75-41(4) of the IPS, s5-5 of the IPS, s5 of the Bankruptcy Act and s9 of the Act. This is not an isolated example of the law which invites risk, litigation and ultimately increases costs.

It is our position that a complete review of the personal and corporate insolvency regimes should be undertaken forthwith, with a focus on harmonisation and consolidation where appropriate. We also propose that this should be compiled within a new Act separate from the Corporations Act 2001 (Cth) and the Bankruptcy Act 1966 (Cth).

Notwithstanding the above, we refer to the various components of the terms of reference and make the following submissions, adopting the headings where appropriate:

1. Recent and emerging trends in the use of corporate insolvency and related practices in Australia.

   It is clear that the measures implemented by the then federal government in response to the COVID-19 pandemic, including Job Keeper, Job Seeker, insolvent trading moratorium, moratorium on landlords and debt collection etc resulted in an almost immediate and sharp decline in insolvency and insolvency related work despite the hardships suffered by business.

   This was supported further by the Australian Taxation Office not taking active collection steps in regard to debts due.

   The collection activity by the Australian Taxation Office is a significant driver for directors of companies in financial distress or insolvency to seek further professional advice. In the continued absence of any robust collection activity directors will continue to fund their ailing businesses utilising the Australian Taxation Office as its bank. This creates an inequitable competitive market whereby those that are compliant with their taxation obligations are disadvantaged against those that are not.

   We do not intend to discuss the broader aspect of material shortages, price pressures, inflation as this is not our field of expertise, other than to say the directors, stakeholders, and advisors we are dealing with are citing these pressures as their reasons for failure correlated with the impact of the COVID-19 pandemic.

   We will address the specific implementation of small business restructuring and simplified liquidations at point 2 below and will not address them here.

2. The operation of existing legislation, common law and regulatory arrangements.

   <u>Small Business Restructuring</u>

   The small business restructuring reforms, in our view provide an appropriate mechanism for small business to restructure, however there is significant problems inherent in the process that are either open to abuse or do not function correctly.

As an example, the absence of any disclosure requirements relating to the asset position of the company and any comparison to any return in a liquidation scenario. In all matters we have undertaken to date, especially where the Australian Taxation Office is a creditor, we have been asked to provide this information, yet it is not a requirement of the legislation.

At the conclusion of a plan, which is operated by the practitioner and where the practitioner does all things necessary to distribute and finalise the plan, requires a director to issue a notice of finalisation which is required to be lodged with ASIC. This is both unnecessary and backwards in the operation of the plan.

Further the GST treatment under both the restructuring plan and as practitioner, currently fall outside the insolvency regime in the applicable tax act. Resulting in the ATO determining that there is no enterprise or GST registration requirements. Given there are fees and charges within the plan period which require GST to be paid, denying the credit for same is nonsensical and it should be remedied by including this appointment in the tax act. The current result is that there is a tax refund that will be paid to the company the subject of the Small Business Restructuring Plan from funds that they had contributed under the restructuring plan for the benefit of its creditors.

We contend that the above measures are two examples of issues arising when legislation is rushed into operation with little consultation with the profession. There are many more similar issues that with appropriate changes would make this legislation more workable and effective.

Simplified Liquidations

We maintain our view that the current process of simplified liquidations is not fit for purpose.

It appears that the intention for this legislation was to reduce the costs and complexity of a “standard” liquidation where certain circumstances were met by “simplifying” it.

This process only commences, after, a “standard” liquidation has been commenced which ironically creates more work. The less work predominately relates to reduced investigation and reporting requirements.

There are little to no costs savings in its current form. We also question whether it has any purpose as a mechanism in the Australian insolvency landscape as the traditional path of liquidation operates effectively. There are mechanisms within the Act that allow a practitioner to not incur costs or undertake works where there are not enough funds to meet their costs. There are also investigations of a minimum standard which are necessary for a robust insolvency regime and corporate market, to continue to identify poor or inappropriate behaviour whether by directors, advisors, creditors, or other stakeholders.

It is then incumbent on the regulator to enforce sanctions as rules and laws requiring regulation cannot exist appropriately without enforcement and punishment.

3. Other potential areas for reform

   a. Section 600F of the Corporations Act 2001 (Cth) ("the Act") provides a limitation on essential service providers to insist on payment of debts incurred prior to the external administration of a company as a condition of supply to the externally administered company.

      Essential service includes telephony and electricity providers.

      More often that not, the company now has data stored in cloud environments or utilising software usually managed by third party providers. The data, whilst a company record required to be produced by a director, is often not produced due to non-payment for services. Accessing this data is often not possible without negotiating a payment as these data storage or software providers.

      They are currently not defined as essential services. It would assist registered liquidators and by extension the stakeholders of an externally administered entity for:

      i. service providers of software / data or its storage to be classified as essential service providers.
      ii. The definition to include all external administrations

   b. Sections 438C and 530B of the Act provide a voluntary administrator and liquidator, respectively, the right to books and records of the Company. Often there are parties that are in possession of records that relate to the Company but may not necessarily be a "Company record".

      For example, a lawyer, an accountant or in the most severe cases, a phoenix promoter has a copy of company record but not an original record. They refuse to provide such records on the basis that they are their own records and not those of the company.

      In circumstances where a company has been transferred prior to the appointment of an external administrator, whether a phoenix or not, if the records are included in the transfer, provision has been refused on the basis that ownership of the records has changed to the new entity and the records are no longer the records of the company.

      Changing the sections above to include records that "relate to the dealings" of the company, or "a copy of a company record" to be included would greatly assist registered liquidators in discharging their duties.

c. Section 561 of the Act is currently a section which has great uncertainty around its operation. Secured lenders adopt one view, practitioners regularly a differing view and recently the Department of Employment and Workplace Relations, and previously the Attorney Generals department have a completely different view.

The section operates to advise that circulating assets subject to a secured charge should be paid to employees in respect of their wages, superannuation and entitlements in priority to that charge. Until recently, it was not uncommon for practitioners to claim their remuneration and expenses in relation to the liquidation from these proceeds in priority to employee entitlements as afforded by section 556. There is case law that provides for this in Re Saker [2014] FCA 771.

However, there is a House of Lords decision in Buchler v Talbot [2004] UKHL 9, that determined sections similar to s561 and s556 which stated that remuneration and expenses of a liquidator were not afforded any priority. Following the above decision, the UK Government reversed the above decision, making changes to its Act to provide that the remuneration and expenses of a liquidator be afforded its appropriate priority. There were specific protections also inserted to ensure that liquidators did not utilise secured funds to run recovery actions without approval of the secured creditor.

The inherent uncertainty in the current landscape in Australia needs to be remedied forthwith. It is notable that the DEWR are seeking a test case. However, given they have a specific interpretation of the Act we do not consider further case law an appropriate vehicle. The government needs to make legislative change similar to that in the UK.

d. Proposals without a Meeting

The Insolvency Law Reform Act 2016 (Cth) introduced changes to the Act which included a new provision for allowing liquidators to seek approval of certain matters by way of a proposal without a meeting. The requirement allows creditors to vote on a singular proposal without necessitating a meeting of creditors, thus reducing costs. These proposals often deal with remuneration, disbursements and early destruction of books and records.

Section 477 of the Act requires a liquidator to convene a meeting of creditors where there is a compromise of a debt greater than $100,000 or they wish to enter into an agreement of greater than three months.

There should be legislative reform to enable liquidators to seek approval under 477 utilising the proposal without a meeting regime rather than necessitating a meeting as is currently the case.

Notably, in the proposal without a meeting regime, creditors are provided with three options, approve the proposal, not approve the proposal, or object to the proposal being resolved without a meeting of creditors. Accordingly, the rights of creditors are preserved even if the regime was adopted.
Matters that often require 477 approvals include, offers of settlement of any sized debts (payment in full) with payments by instalments that exceed three months, litigation funding agreements, compromise of large debt claims including debit loan accounts of directors.

In addition, it would also benefit all stakeholders for multiple resolutions to be included in a single voting proposal, which is similar to what already occurs for a specific proxy when meetings are convened. Creditors already comment about the volume of correspondence and forms, this would reduce that burden somewhat.

e. Unfair Preferences

There has been more recent discussion regarding a reduction in the unfair preference time frames. Currently six months prior to the relation back date, which is usually the date of an appointment of an external administrator.

We do not support a reduction in the time frame as we see this as being open for abuse. In particular, a director could pay friendly non-related creditors and then sit out a shorter period to avoid it being clawed back as a preference denying other creditors their share of the limited asset pool.

Similarly, directors may be pressured into making a payment and then not appointing an external administrator for a period for the same reasons.

There is currently defences available for creditors who receive the money in good faith, have no knowledge of insolvency etc. Notably, creditors are making lending decisions to extend credit to another company and therefore should bear that risk, similarly they are also bearing a risk if they meet the elements of an unfair preference, ie they have knowledge or ought to have suspected the insolvency and received more than they would in the winding up of the company.

The continuation of this regime ensures that creditors receive their rightful share of a limited asset pool. Again, education here would benefit all parties.

We would support a change that imposed a minimum sum on the preference amount. Whilst we see this as still open for abuse, the quantum of that abuse is capped.

f. Safe Harbour

We note that The Review of the Insolvent Trading Safe Harbour was tabled before Treasury on 24 March 2022. We are supportive of most of the comments and recommendations contained in that Final Report.

g. Compulsory company deregistration

The Australian Securities and Investments Commission currently has a process whereby a company that fails to pay for its annual return for two consecutive years is deregistered after advertising the pending deregistration on their website.

We have had several directors approach us after deregistration enquiring about liquidating the company. Often, they are unaware of the deregistration, and often the company has significant debts including debts to the Australian Taxation Office. A simple check from ASIC to the ATO would alleviate this issue.

Similarly, we have had creditors approach us to consent to act for a winding up of a company, only to learn that it has been deregistered and thus would require an application to the Court to reinstate the company to then pursue the debt. Which also deprives them and other stakeholders of an investigation into the affairs of the company and the conduct of its officers.

Our final, concern on this point is that we are aware of phoenix promoters utilising this “non payment deregistration” to their advantage, creating impediments to creditors to pursue the company and provide for appropriate investigations into its affairs and the conduct of its officers.

h. Trusts

We are regularly faced with the prospect of a being appointed to the corporate trustee of an insolvent trust. Often the trust deed cannot be located, and it has little assets. However, the current status is such that appointee needs to make an application to the court to be provided the right to deal with trust assets, amongst other things.

This is not a new issue as such issues were identified in the Harmer Report, however appropriate recommendations have never been adopted.

The Court, practitioners and all stakeholders would benefit from time and costs savings if practical reform was made to enable practitioners to deal with trust assets as the corporate trustee in the absence of a replacement trustee prior to their appointment, reversing the costs and the onus on the appointors.

i. Phoenixing

We maintain that persons advising on insolvency need to hold a license to provide such advice. Registered liquidators would be automatically licensed. There should be strict liability offences associated with providing unlicensed advice and unlicensed advice should be a specific offence, including automatic liability pursuant to section 79 of the Act. Section 79 deals with accessorial liability in aiding and abetting a breach of duty.

We should adopt language that separates phoenix promoters from pre-insolvency advisors and legitimate turnaround and restructuring professionals.

j. Directors

To become a director, you should have to pass a course. Such course can be run online via ASIC at a cost to the director. That could assist in funding ASIC and meeting course costs. The course should include minimum basic standards around director duties, solvency and maintenance of books and records.

The course should also reference, basic financial literacy involved with reading financial statements, supplying goods and services on credit and the PPSA.

A course of this nature does not stifle innovation or create a barrier to entry as has been alleged, and in our view, if established, the barrier is not too great when weighed up against the benefit of directorship which includes the provision of a corporate veil.

k. General

The above, is not an exhaustive list, but serve to highlight some of the shortfalls in recent legislative amendments, the negative impacts of piecemeal changes to insolvency legislation and the inadequacy of laws adopted over thirty years ago.

We also suggest that you should include the DPP in your review to close some of the loopholes for prosecution by ASIC. i.e. No prosecution for a director for non-delivery of books and records if they deliver up one page of records.

4. Supporting business access to corporate turnaround capabilities to manage financial distress.

We are of the opinion that there is sufficient support and access to support business access to corporate turnaround capabilities and to manage financial distress. The inability of directors to identify it, or unwillingness to accept it, is often the issue, which may in part be resolved through education as detailed at point 3(h) above.

Market forces would be such, that if further demand existed in that area due to a lack of access, that advisors would seek to fill that void and if they did, they should be licensed.

5. The role, remuneration, financial viability, and conduct of corporate insolvency practitioners

   We are clearly not an independent party to this question. We maintain that a robust economy relies, in part, on a robust and well-funded insolvency regime to ensure the efficient recycling of capital, investigation into the affairs of a company and the conduct of its officers and reporting behaviours that breach the standards required of the Act and the public.

   More regularly a company does not hold material assets yet has significant liabilities. The current Assetless Administration Fund provides a mechanism for further investigation and potential prosecution of poor conduct assisting in the maintenance of a robust system. The education detailed at 3(h) above would inform directors to identify signs of distress earlier and seek assistance and provide directors of creditor entities to not provide credit that exposes them financially. The result may be a stronger corporate economy with less insolvencies.

   The Cost Recovery Implementation System (CRIS) is a hindrance to a robust and well-funded insolvency regime, whereby liquidators are required to meet the costs of regulation with little evidence of how those costs are derived. Registered liquidators are in and of themselves part of the regulatory system and as such should not be burdened with an inequitable cost recovery system.

   We maintain as per our previous government submissions that each company could meet the entire cost of the liquidator cost recovery by implementing a fee of less than $4 per company return. We also maintain that lodging their statement of solvency as required in the annual financials at a cost would cover this amount and would also make directors take their solvency declarations more seriously. This may then change behaviours by directors taking earlier advice when faced with financial distress.

6. The role of government agencies in the corporate insolvency system.

   We repeat our earlier statement in this submission that insolvency laws should be enacted within a new standalone Act after the completion of a wholesale review of insolvency laws. As a corollary to this, we would advocate for a standalone Commission separate from ASIC to regulate the new Act and the profession. This could be funded from company returns as detailed at 5 above.

   We otherwise refer to our previous comments above in relation to ASIC and its role and the changes to the current system that we advocate are necessary.

We also refer to our previous comments regarding the reluctance or inability of the ATO currently to enforce debts via the various regimes at its disposal. In the absence of enforcement companies will continue to use the ATO as a bank resulting in inequitable and anticompetitive outcomes between the compliant and non-compliant.

We further refer to our comments regarding the Assetless Administration Fund and repeat that we consider it a vital tool in the operation of a robust insolvency regime and should be well funded to ensure matters requiring further investigation and reporting are investigated.

7. Any corporate insolvency matters

We restate that we are firmly of the opinion that the Australian insolvency regime is in need of a complete review of both corporate and personal insolvency laws and their operation. Consideration should be given to the matters raised within this submission and the submission of others as this submission does not seek to list every current problem within the Act or its operation.

The Harmer report gave us significant change of a world standard insolvency regime and it is overdue that we again put ourselves at the forefront rather than relying on piecemeal changes and test cases driven by the interests of the parties that are seeking them.

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Should you have any queries in relation to this submission, do not hesitate to contact us.

Yours faithfully

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