CORPORATE LAW TEACHERS SUBMISSION ON INSOLVENCY LAW REFORM

Executive summary
We recommend that the Joint Committee review:

1. How Australia's corporate insolvency laws can better facilitate and support restructuring and corporate rescue, including:
    a. Review of Australia's insolvent trading laws (including the provision of a safe habour defence for genuine restructuring)
    b. Protecting businesses involved in restructuring from contractual termination clauses (ipso facto clauses)
2. Whether Australia needs a more nuanced set of insolvency procedures to deal with the different needs of large and small businesses in financial distress and insolvency
3. How illegal phoenix activity can be identified and addressed across government agencies

Insolvency Law Reform: Facilitating restructuring and corporate rescues

Corporate insolvency law has traditionally been focused on providing an efficient realization of an insolvent company's assets to provide for distributions to creditors. Most insolvent businesses operated within a domestic market and had large fixed asset bases of equipment that were subject to security provide by a single bank or a small group domestic banks. Modern business operates within a global market for capital, products and services. Corporate credit arrangements are a mix of several levels of secured creditors, often maintaining complex financial contracts involving a range of exotic derivatives and inter-creditor agreements. The decline of domestic manufacturing and the rise of the services sector (particularly professional advisory and financial services) has meant that the asset base of most businesses is not based on owning large pieces of equipment that are subject to bank mortgages. Businesses depend increasingly on human capital, intellectual property and intangible assets. Services and advisory businesses depend on maintaining key contracts with customers and suppliers for their viability. Traditional insolvency law is not suited to this environment as the appointment of an insolvency practitioner will result in the termination of contracts and the departure of key employees. Traditional insolvency law does not easily facilitate restructuring and corporate rescue attempts.

The debate about insolvency law has shifted around the world to focus on attempting to save businesses before they become terminally distressed and enter formal insolvency proceedings. Corporate rescue laws in most of Australia's major trading partners and neighbours in the Asia Pacific, including China, Hong Kong, Singapore, North America and the UK have recently revised their corporate insolvency laws, or are currently reviewing their laws, to facilitate restructuring rather than focusing mainly on dealing with insolvent companies. Australia has not undertaken a major revision of its corporate insolvency laws since the implementation of the Harmer Report in 1992.

Australia's corporate insolvency laws need an urgent review to focus on restructuring, turnaround and corporate rescue. Issues that require particular attention are insolvent trading for directors (which discourages participation in a workout/restructuring), a safe harbour for personal liability and the treatment of contractual terms that terminate on insolvency (so called ipso facto clauses) that rip value out of business upon formal insolvency. These issues have strong support for change from the insolvency profession and from the banking, credit and financial services industries. We note that the Australian Restructuring Insolvency and Turnaround Association (ARITA) and the Turnaround Management Association have been advocating these reforms for the past 4 years (since the

Treasury's aborted Safe Harbour for Insolvent Trading review in 2010), with ARITA releasing a major law reform discussion paper on 15 October 2014.

One-size fits all no longer works

Australia's insolvency laws are largely based on a one-size-fits all model under voluntary administration, liquidation and schemes of arrangement. The current insolvency mechanisms impose a substantial cost structure on insolvent companies. Liquidations typically cost at least $15,000 or more, and voluntary administrations typically cost at least $50,000 or more. This makes getting good insolvency advice very difficult for small and micro businesses.

There are a large number of liquidations that are assetless (driven by enforcement from government revenue authorities) with the amount of unfunded work done by insolvency practitioners estimated at $48 million per year (estimated by a report by the Insolvency Practitioners Association-now ARITA, in 2012). There are many businesses that literally cannot afford to enter insolvency proceedings if not pushed into proceedings by the ATO or ASIC. This results in an unknown number of assetless, non-functioning zombie companies sitting in the economy. There is widespread illegality that goes unreported due to the lack of scrutiny by liquidators or ASIC within this space. Concerns about the use of insolvent companies for money laundering, drug trafficking and other illegal activities are widespread within the insolvency practitioner community.

There is strong support within both the business and insolvency communities for a faster and more streamlined insolvency procedure that will allow for low asset/no asset liquidations. A streamlined procedure will also benefit insolvencies that are essentially single asset sale processes. This is provided for in other regimes, such as the judicial sale process in the United States and pre-pack procedures in the UK.

Finally, the voluntary administration regime that currently operates in Pt 5.3A of the Corporations Act 2001 (Cth) makes no distinction between small, medium, large and enormous insolvencies. This necessitates several court applications for larger and more complex matters, which drives up costs and slows down the process. It also means that smaller companies are subject to a range of procedural and reporting obligations that may not provide value for creditors. Other insolvency regimes such as Canada, the US and the UK provide a more nuanced approach with specific procedures for large and small insolvencies.

Curbing illegal phoenix activities

The current insolvency enforcement regime is based largely on private enforcement by liquidators and supervision of liquidators by ASIC. This system contains a fundamental flaw that liquidators typically have little funds to investigate or pursue delinquent directors so their role involves mostly superficial reporting, based on a checklist, tick a box procedure. ASIC receives thousands of reports from liquidators each year and yet very few actions are taken in respect of these reports. ASIC frequently requests further information, but there are no funds available to pursue further investigations. ASIC's enforcement role on directors of insolvent companies is focused mostly on compliance matters-have they completed the correct forms on time? This is demonstrated by the enforcement reports issued by ASIC that focus on 'small business compliance' matters where low level administrative and criminal sanctions (fines) apply. ASIC brings very few insolvent trading cases and rarely exercises its banning powers-at least based on what it reports to the public.

There is a clear need to see curbing illegal phoenix activity as more than a mere compliance issue. There is a need for a whole of government approach to address criminal phoenix activity across the economy, with the building and construction and labour hire industry particularly prominent in this area. This task is too big for ASIC alone, because it has a broad range of other responsibilities. A specialist team is needed that includes, ASIC, AFSA, ATO and Fair Work officers to address the problem.

We also advocate initiatives to harmonise insolvency laws by creating a single insolvency regulator whose sole focus is on insolvency reporting, investigations and enforcement rather than dispersing these functions throughout levels of government agencies.

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