DEPARTMENT OF THE SENATE

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Where there is a will there is a way: Addressing regulatory failure, regulator failure and information asymmetry.

A report to the Senate Inquiry into Liquidators and Administrators

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1. BACKGROUND

Regulations and the actions of the regulators that apply them, will never eliminate behaviour that is deliberately designed to defeat their purpose. In fact, regulations will often establish the parameters in which misbehaviour can be achieved. Most of this behaviour is at the margins and does not normally reflect the mainstream compliance of most, with both the spirit, and the letter of the law.

This submission aims to focus on several factors which need to be addressed in improving the current regulatory environment and the functions of the key regulators of liquidators and administrators. The submission seeks to directly respond to the inquiries terms of reference, namely: *Investigating the role of liquidators and administrators, their fees and practices and the involvement and activities of the Australian Securities and Investment Commission (ASIC), prior to and following the collapse of a business.*

A specific influencing factor leading to this inquiry were the practises of one Mr Stuart Karim Ariff, across a broad range of entities and time. To this end, Section 2 provides a case study overview of Ariff's practises and the implications of the failure to address certain systemic issues, culminating in *Australian Securities and Investment Commission v Stuart Karim Ariff* (*ASIC v Ariff)*[1]. This case study highlights how certain parts of the current legislation, combined with a reactionary approach by professional bodies and regulators, combined to allow a "rogue administrator" to continue to operate, long after creditors and members had made numerous complaints through all available avenues. However, it must be noted that whilst the wilful misbehaviour of such an individual will never be prevented, it can be actively deterred.

[1] *Australian Securities and Investment Commission v Stuart Karim Ariff* [2009] NSWSC 829.

In the wake of the call for submissions into this Senate Inquiry into liquidators and administrators there have been a number of suggestions for law reform from the Minister for Financial Services, Superannuation and Corporate Law, the Hon. Chris Bowen MP, relating to changes to the current options for directors trying to operate a company out of financial crisis.[2] Similarly there have been indications of further reform to increase the powers of ASIC in dealing with directors who breach their duties.[3] This report also briefly discusses its reaction to these proposed reforms, particularly in regard to the current operating mandate of ASIC.

Those protecting this industry cannot be reactionary, as the administration and liquidation of companies comes at great cost, both financially and otherwise, to a wide variety of parties, including creditors, members, employees and the community. The law must better insulate these parties from the types of behaviour highlighted in Section 2, while ASIC and the professional bodies must act to enforce their obligations to all corporations and sections of the business community.

Section 3 provides an overview of each of the key issues, predominantly related to the Inquiry's terms of reference and details recommendations to address issues highlighted.

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[2] Commonwealth, *Insolvent Trading: a safe harbour for reorganisation attempts outside of external administration* (2010).
[3] 'ASIC to become mean watchdog,' *The Newcastle Herald* (Newcastle) 29 January 2010, 2; Matthew Stevens, *ASIC's guns blazing, but can they shoot straight?* (2010) The Australian Online <http://www.theaustralian.com.au/business/opinion/asics-guns-blazing-but-can-they-shoot-straight/story-e6frg9if-1225824471425> at 29 January 2010.

2. THE ARIFF CASE STUDY

***I suspect that our Mr Ariff is a bit of a cowboy*[4]**

There are many who can detail from direct experience the practices of Mr Stuart Karim Ariff (Ariff). It is not our intention to provide a detailed account of the practices and behaviours that led to Ariff's life long suspension from insolvency practice. These are summarised and available publicly in Ariff's affidavit evidence, provided by way of consent orders agreed in *ASIC v Ariff*; and in various related cases and the print media. Ariff is not an isolated case, see for example the Victorian case of *Vartelas*[5]. However, the admitted and observed practices of Ariff highlight certain elements found in other cases against practitioners and therefore provides an excellent case study.

Some of the events are summarised to highlight several failings of the existing system and to consider options to address the opportunities that can be afforded to those practitioners who seek to exploit their clients.

Once appointed the Voluntary Administrator (VA) gains control over the business and its assets by virtue of Section 437 of the *Corporations Act 2001* (Cth) (*Corporations Act)*. This includes, under Section 437D, the ability to dispose of assets at any value the VA deems appropriate. It took the owners of Carlovers five years to regain control of their business from the (legal) hold Ariff had, whilst others (including Singleton Earthmoving Pty Ltd and Independent Powder Coating Pty Ltd) watched their business completely disappear.

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[4] Commonwealth, *Parliamentary Debates*, House of Representatives, 17 August 2005, 0056 (Joel Fitzgibbon, Member for Hunter).

[5] *Re Vartelas v Australian Securities Commission* (1996) 22 AAR 525; (1966) 14 ACLC 732. In this case Justice Robson of the Victorian Supreme Court found that, in describing the actions of liquidator Paul Vartelas: 'His failures were significant. He failed to ascertain what his appointer was owed. He failed to take proper care to ensure he was not improperly prolonging the receivership.'

Furthermore, once appointed and a fee schedule approved, there is little control over the hours worked and fees accrued in exercising this control. This is compounded by the fact that there are no controls over the associated value of outgoings incurred by the VA. There is also no need to keep returning to the creditors, or creditors' panel, to seek approvals for drawing down fees and outgoings. As a result, Ariff went off to luxury resorts, hired limousines and paid his father (who had no role in the actual administration of Carlovers) a retainer of $10,000 a month in undertaking the Carlovers administration. Even when a forensic accounting report, prepared for the owners of Carlovers, detailing these expenses and that Ariff was using an associated company to provide accounting services to Carlovers (in breach of the Act), there was no action from the regulators (ASIC), nor interest from the professional bodies.

The inherent incapacity to control outgoings, fees and the activities relating to a business under the operation of the VA, meant that Carlovers were in the courts seeking to regain control of the company and watching the administration expenses grow to $10 million over four years, 'which is more than double the company's original deficiency of $4.5m declared by Ariff on July 17, 2003, just after his appointment.' [6]

Another example of this control factor is provided by Ariff's administration of the Armidale YCW Rugby League Club, where he was able to sell a mortgage held by St George Bank for $400,000 to an associate (an alleged money launderer and underworld financial adviser[7]) Tom Karas, effectively allowing him to gain control of the club. This led to Karas appointing a receiver and stripping out the club's fourteen poker machines. For this Ariff claimed

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[6] Adele Ferguson, *Going for broke on a fee spree* (2009) The Australian Online <http://www.theaustralian.com.au/business/going-for-broke-on-a-fee-spree/story-e6frg8zx-1225738870533> at 18 January 2010.

[7] Gary Hughes & Adele Ferguson, *Gillard joins fray over gutted footy club* (2008) The Australian Online <http://www.theaustralian.com.au/news/gillard-joins-fray-over-footy-club/story-e6frg6o6-1111117669887> at 18 January 2010.

remuneration of $736,300 in 'fees and other expenses', while at the same time 'the club's original debts of about $540,000 have more than doubled to $1.3 million.'[8]

Singleton Earthmoving provides another example of asset stripping and in particular the blatant destruction of a healthy company. Under Ariff's direction the assets of the company were seized and the business effectively shutdown, with the loss of 25 jobs. A detailed summary of the fate of Singleton Earthmoving was put to the House of Representatives in 2005 by the Hon. Joel Fitzgibbon, several years before any action would be taken regarding those activities.[9]

The major outcome that the behaviour of Ariff highlights is that small firms are very much exposed when a practitioner operates in the way that Ariff elected (although even large firms like the Carlovers Group were also captured by Ariff's actions). This is accentuated by the fact that small businesses are more likely to require external specialist advice, which under existing laws will tend to involve VA, rather than seeking to turn the business around without recourse to such a formal mechanism. This is often driven by Section 9 Definitions in the *Corporations Act*, which defines a director of a company to include not only the appointed directors, but any person who has a level of influence or control over the board; or is instrumental in top level management functions, such as arranging significant changes in operations or transactions. The Federal government has recently recognised this impediment and has issued a working paper for comment directed toward facilitating options for businesses seeking to trade out of difficulties while technically insolvent.[10] This issue is examined in Section 3 of this submission.

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[8] Ibid.
[9] Fitzgibbon, above n.4.
[10] 'Insolvent Trading: A safe harbour', above n.2.

Despite repeated complaints, over a number of years, ASIC did not respond until the body of evidence, mainly through litigation taken by aggrieved individuals and creditors, was too great to ignore the matter of Ariff. When ASIC did finally act, its response was comprehensive and professional, until they took the "show trial" option; accepting consent orders and not pursuing Ariff for his clear and repeated breaches of the *Corporations Act* (and related fraudulent and criminal behaviour). Ultimately, while Ariff admitted to misappropriating several million dollars from clients, he was effectively allowed by ASIC to claim in "error", rather than stand trial for misconduct, fraud and actions in direct breach of the civil and criminal codes.

One argument posited for the show trial option, was that the consent order path saved six weeks of legal and related costs. However, the benefit of pursuing this case would have demonstrated that ASIC has a mandate to vigorously pursue the type of egregious behaviour exposed in the Ariff case, and further support a focus on the interpretation of the law by the courts, which has now been required by this Inquiry. It is time that regulators such as ASIC came to appreciate that they are required to actively apply the laws that come under their jurisdiction.

Further, the consent order in *ASIC v Ariff* included orders to pay compensation to the various companies set out in Annexure C of the joint submission agreed by the two parties[11]. The total agreed compensation was $4,979,312.93. Did ASIC, in agreeing to the consent order, really consider that Ariff would make these payments and, given his track record, wouldn't seek relief under the *Bankruptcy Act*[12]?

[11] *Australian Securities and Investment Commission v Stuart Karim Ariff* [2009] NSWSC 829.
[12] *Bankruptcy Act 1966* (Cth).

The standard practise adopted by ASIC is that complaints are to be lodged online[13]. Numerous complaints were made regarding Ariff and each time an automated ASIC response was sent to the complainant, indicating that their complaint was now registered on an ASIC database. Even after, as mentioned above, the Member for Hunter (Hon. Joel Fitzgibbon) called for ASIC to investigate Ariff's behaviour with respect to his administration of Singleton Earthmoving in the Federal Parliament in 2005, there was no response from ASIC. ASIC's capacity to investigate and deal with complaints needs to be considered.

Similarly the professional bodies that accredit practitioners, namely the Chartered Accountants (CA) and the Insolvency Practitioners Association (IPA) failed to act until well after it was clear that they should have investigated the volume of complaints made about Ariff. When Ariff was described by Justice White in the case of *Wambo Coal Pty Ltd v Ariff*[14] *(Wambo Coal*) in 2007 as having 'wilfully shut his eyes to the obvious' and had 'wilfully and recklessly failed to make further inquiries for fear of learning what he did not want to know'; this should have been enough to cancel his practice certificates and memberships of the CA and IPA. Instead, the CA fined him $20,000[15] (less than half of what he withheld unlawfully from Wambo Coal). In fact, Ariff has never had his CA membership revoked, instead the CA's pressured him to resign after *ASIC v Ariff* was concluded (but this may not exclude Ariff rejoining in the future). This was a very convenient outcome for the CA's, as it avoided the cost of any investigation and inquiry by the CA's, particularly when the prospect of recovering the costs from Ariff were zero.

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[13] ASIC, *How ASIC deals with your complaint* (2009) Australian Securities and Investment Commission http://www.asic.gov.au/asic/asic.nsf/byheadline/Complaining+about+companies+or+people?openDocument at 18 January 2010.
[14] *Wambo Coal Pty Ltd v Stuart Karim Ariff & 1 Or* [2007] NSWSC 589.
[15] Chartered Accountants, *Professional Conduct Tribunal February 2008* (2008) Chartered Accountants <http://www.charteredaccountants.com.au/A121111489> at 18 January 2010.

Chief Justice Bergin in her judgement in *ASIC v Ariff* directly indicated her concern that 'the accounting bodies, as opposed to the bodies that regulated liquidators, should also be advised of the orders to which the defendant has agreed.'[16] This statement came in response to the Chief Justice being informed that Ariff continued at that stage to practice as an accountant. In fact, Bergin CJ expresses the direct view that these accounting bodies form part of the regulatory function when she said: 'I intend to make an order that a copy of the Short Minutes of Order and Annexures *be served on the various accounting bodies that regulate the accounting profession*.' [emphasis added][17] This is in contrast with the way the CA's refused to investigate Ariff while involved in the court system.

The CA's refused to investigate Ariff while the *Wambo Coal* case was before the court. This raises the question: What is an effective role for such a body as the assumed gatekeeper on quality in the profession? Further, why didn't they investigate complaints that weren't before the courts? These professional bodies need to be required to investigate and report on complaints.

Records held by VA's are held at their discretion. Under Section 438 of the *Corporations Act* the owners must provide the VA with all books and records at the time of appointment and the failure by owners to provide further assistance as required by the VA under Section 438B is an offence. Where a VA finds that an officer of the company has committed an offence in retaining information or property, or has breached a duty to the company, the VA must lodge a report about the matter with ASIC and provide ASIC with any necessary assistance (Section 438D(1)). It would seem that where the reverse applies and the VA is withholding information, or failing in their duties, that the officers of the affected company have limited if

[16] *Australian Securities and Investment Commission v Stuart Karim Ariff* [2009] NSWSC 829 at [36].
[17] Ibid.

any recourse, other than to commence action to have the VA removed by the courts (which can only be done on application by ASIC or a creditor).

After Ariff agreed in the Supreme Court to stand down as the administrator of Carlovers (and despite the fact that the company was to be returned immediately to the original holding company Berjaya Group), Ariff organised for the company records to be removed from Carlovers office and some nine hours later they arrived at Ariff's Sydney office (having only to travel about 30 kilometres). Along the way it seems some documents were either destroyed or held elsewhere[18]. Lawyers for Berjaya were at a loss as to why the documents were removed at all and whether they would ever recover a complete set of records.

Another issue which has arisen more recently, as a consequence of the liquidation of Ariff's insolvency practice and his own bankruptcy, is that records held in storage have not been released, or have been destroyed (because storage fees have not been paid). This makes retracing Ariff's steps very difficult, if not impossible, even for the accountant administering Ariff's bankruptcy.

Ariff allowed his professional insurances to lapse. While this is a professional and legal requirement, Ariff's creditors and ex-clients should not be too disappointed, because his insurance had no effective tail (carry forward to cover errors made in the current year, but not found until a future period) and the insurer will not cover deliberate misbehaviour, fraud or associated wilful criminal behaviour. However, the failure has a policy implication that is discussed in Section 3.

[18] Jason Gordon, 'Documents taken away- Carlovers files removed from office' *The Newcastle Herald* (Newcastle) 3 November 2009, 9.

Ultimately, at this stage, Ariff has not had to stand before a court of law and answer for his behaviour[19], which has resulted in the loss of millions of dollars in assets, operating income and jobs (without considering the personal distress Ariff's behaviour created for many of the business owners and their families). This case study identifies the deficiencies surrounding voluntary administration and liquidation, where the insolvency practitioner can apply the strict letter of the law to personal advantage, compounded by a reluctance and at times failure on the part of the regulators (including professional bodies) to respond at the expense of creditors, members and shareholders. So under the current laws and apparent mode of operation of the regulators, the practices adopted by Ariff and considered in this case study could be readily achieved. Section 3 of this submission directly considers some key areas for reform, with the aim of supporting changes which will allow for effective insolvency practice and appropriate safeguards for business owners and creditors.

[19] However recently it has been reported that Federal Funding has been approved by the Insolvency Trustee Service Australia, so that the trustee may examine the actions of Ariff. This will require Ariff to stand before the Federal Court at some stage in the next few months: Matthew Kelly, 'Liquidator set to face examiners' *The Newcastle Herald* (Newcastle) 23 January 2010, 23.

3. ADDRESSING KEY ISSUES

3.1 The VA Option

3.1.1 Turning a Business Around

The majority of businesses operating in the Australian economy have limited access to internal or external specialist advice. The key professional advice readily available comes externally from either the business accountant and/or banker. Both of these professionals will provide advice, but this is normally with a focus on ensuring compliance with their own legal obligations and those of the owners. This will mean that where a company is shifting to, or is insolvent, the advice will focus on the owners' obligations to ensure they are not trading whilst insolvent.

Under the current requirements of the *Corporations Act*, once a director believes the business to be insolvent, they must not incur any further debts (including trade creditors). As such, there are limited options to trading out of insolvency under this requirement.[20] The result is that most firms move to appoint a VA under the provisions of the *Corporations Act*. As detailed in Section 2, this means effectively handing business control to the VA. There is no opportunity to use external professional consultants to develop and implement a turnaround strategy, as anyone acting in such a consulting role would most likely be deemed a de facto or shadow director. There needs to be an opportunity to take appropriate professional advice and act upon it in the interests of recovering the business and moving to ensure all creditors are paid. This means a significant change to the *Corporations Act*.

This would appear to be recognised by the Commonwealth government in the recent release of a discussion paper in January 2010 by the Minister for Financial Services, Superannuation

[20] *Corporations Act 2001* (Cth) s 588G.

and Corporate Law (Hon. Chris Bowen MP)[21]. Minister Bowen makes the issue very clear in his foreword to the discussion paper:

> Australia possesses a modern, robust and efficient corporate reorganisation regime in the form of its voluntary administration procedures. However, placing a company into voluntary administration may not always represent the most appropriate method to effect a corporate rescue. Informal work-outs play an important role in preserving a troubled business and protecting the interests of its creditors, shareholders, employees. [22]

The current constraint, clearly recognised by Minister Bowen, has also created a culture of deal making with business owners via the VA process, allowing operators who find themselves insolvent or close to it, to use a VA as a way of extracting themselves from their poorly operated business and starting over. This has led to the Assistant Treasurer (Hon Nick Sherry) issuing his own discussion paper in late 2009 concerning so called 'phoenix companies.' The phoenix company was summarised succinctly by Ferguson:

> Phoenix companies refer to the practice of closing a company one day and, like the bird in Greek mythology, rising from the ashes and opening another company with the same assets and similar name to avoid paying taxes, wages and other bills with the sole purpose of cheating creditors out of their money. [23]

Minister Sherry is aiming to tighten laws and directors' duties to stamp out the growing number of such arrangements, but this could work against the options provided in Minister Bowen's discussion paper. Any changes to the legislation directed at phoenix companies should consider the potential impact on business rescue options now under consideration.

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[21] 'Insolvent Trading: A safe harbour', above n.2.
[22] Ibid, at V.
[23] Adele Ferguson, 'Sherry's insolvency law changes seem draconian', *Sydney Morning Herald Business Day* (Sydney) 25 January 2010.

Minister Bowen's paper details three options. The first (Option 1) being the maintenance of the status quo, which really is not appropriate. The two reform options labelled under the banner: Options for a safe harbour, are:

Option 2: A business judgement rule for insolvent trading. The business judgement rule was introduced in the CLERP 9 reforms of 1999 [24] to promote optimal corporate governance structures without compromising director's flexibility and innovation. This option would involve extending this rule to apply to directors decisions whilst insolvent (or moving toward insolvency), giving protection for any reasonable and informed decision undertaken in the interests of a work out. The discussion paper details the elements of the rules application at section 5.3.6:

> The rule would operate so that directors would be relieved of the duty not to trade whilst insolvent if the following elements are satisfied:
>
> - The financial accounts and records of the company present a true and fair picture of the company's financial circumstances at the time that the rule was invoked;
>
> - The director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time;
>
> - It was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring; and

[24] *Corporate Law Economic Reform Program Act* 1999 (Cth) (CLERP 9).

- The restructuring was diligently pursued by the director.[25]

Option 3: Moratorium. Directors would be able to openly and expressly invoke a moratorium from the duty not to trade whilst insolvent for the purpose of attempting a reorganisation of the company outside of external administration. The moratorium would apply for a limited period and would be subject to termination by creditors.

RECOMMENDATION 1 – WORK OUT OPTION

The elements of the extended business judgement rule and the moratorium option proposed in the Commonwealth Governments discussion paper: Insolvent trading: A safe harbour for re-organization attempts outside of external administration (January 2010) be implemented through changes to the *Corporations Act*.

This would address the issues relating to shadow directors and provide clear direction as to the obligations of directors and professional advisers through the work out process. Involving creditors in the process ensures that they are aware of the risks to their own businesses and allows for their input. Before the directors can register a moratorium period, they will need to conform with the business judgement rule requirements outlined above, and in addition, have a detailed work out business plan, with clearly identified milestones and report back dates. The work out plan has to be approved by 75% of creditors (based on the relative debt of each creditor) and registered with ASIC. Any business approached for goods and services provided on credit will need to be formally advised a moratorium period is in place and sign a register indicating that such advice has been received and is acknowledged. The moratorium on liability applies to all directors and advisers, provided they act within the requirements of the moratorium provisions, but naturally will not apply to actions or decisions which are dishonest or prefer the shareholders over creditors.

[25] 'Insolvent trading: A safe harbour' above n.2, at vi.

3.1.2 Limiting VA Control

As outlined in Section 2 above, once appointed the VA has virtually absolute control over business assets and operations. This control allows too much discretion on the part of the VA. While it is recognised that the VA will attract liability for actions and decisions under Section 443 of the *Corporations Act*, the discretion available would appear to allow for the unscrupulous actions achieved by Ariff. This needs to be addressed.

RECOMMENDATION 2A - ESTABLISHING A BASELINE VALUE

On appointment the owners are required to provide all business records and property. At this point (and within a reasonable time) the VA should provide a "baseline value" for the business, including the value of all material assets. This should be provided to all creditors as part of the VA process, whether the recommendation is a deed of arrangement or liquidation. This document should be reviewed by an independent VA and all values for material assets certified by an accredited industry valuer. If in the course of the administration the VA seeks to dispose of any material asset and the disposal value is less than 20% of the valuation, then a formal creditors meeting is required before any such disposal can be effected.

Ariff would often use creditor proxy statements to vote through motions put by him at creditor meetings. Whilst it is a breach of the *Corporations Act* for a VA to solicit proxies, it does happen and knowing the level of proxies held may drive VA recommendations and strategies to achieve a majority on key votes.

RECOMMENDATION 2B - REGISTRATION OF PROXIES

Proxies should be lodged with an independent third party agreed by the creditors. The proxies are only valid on a meeting by meeting basis and the VA is not informed in advance as to the level of proxies held by the third party.

As also outlined in Section 2 above, fees and outgoings can be "gouged". On appointment a fee schedule is normally approved for the administration, covering all staff levels at an hourly rate. Charging for services by the hour does not encourage an efficient allocation of time and time allocated can prove difficult to dispute. Often the fees accrued are substantial and there is no formal mechanism for review, other than creditors calling a meeting and requesting a report. There is no real control over outgoings, as the VA can basically operate at their discretion in administering their duties. [26]All of this has proven attractive to some individuals, rorting the latent opportunities this provides.

The setting and accruing of fees and outgoings needs to be addressed. VAs should provide a report on fees to creditors on an agreed regular basis and conform to the industry agreed format, provided in the IPA Code of Professional Practice[27]. Consideration should be given to fixed or capped fee models, again linked to the value of assets under administration. We have deliberately avoided a more structured recommendation around these matters as they are in need of detailed analysis in order to achieve an effective and fair model for all parties.

[26] For the current Australian case law surrounding this area see the summary provided in the New Zealand High Court decision of *Roslea Path Ltd (in liq)* on 17 December 2009, referring to the leading Australian decision in *Conlan v Adams* (2008) 65 ACSR 521.

[27] IPA, *Code of Professional Practice*, (2008) Insolvency Practitioners Association <http://www.ipaa.com.au/default.asp?menuid=242> at 18 January 2010.

3.1.3 Accredited Staff, Consultants, Valuers and Auctioneers

The VA will determine the assignment of professional staff, industry and business expert consultants, valuers and auctioneers. If a VA is seeking to manipulate value or appoint consultants to assist them in activities that are not necessarily in the best interest of creditors, the current process allows the VA this discretion.

RECOMMENDATION 3: APPROVED APPOINTMENTS

At a minimum, the bona fides of all such appointments should be approved by the creditors (applying the 75% majority approach outlined in Section 3.1.1). This could be achieved by way of flying minute (email) including the resume and experience of all such appointments.

3.1.4 Director Registration

There is no onus or requirement that company directors have displayed any knowledge whatsoever of their legal obligations in managing a company. Any adult can be a company director, except for those excluded under the provisions of the *Corporations Act* and these relate to a narrow set of exclusions primarily based around previous criminal record.[28]

A company director is an officer of the company and can take many actions, decisions and commitments on behalf of the business. The company structure affords some degree of protection to the owner/operators and this should be recognised by requiring directors to meet a minimum standard of understanding as to their obligations. If you drive a motor vehicle, you must display an adequate knowledge of the road rules and each motor vehicle has a minimum insurance requirement to meet obligations to any detriment caused to third parties.

[28] *Corporations Act 2001* (Cth) Part 2D.6.

There are 1.7 million companies operating in Australia [29] and it is not realistic that ASIC can ensure that they are operating in line with the requirements of the *Corporations Act*. In addition, ignorance of the law is no protection from it. This leads to Recommendation 4.

RECOMMENDATION 4 - DIRECTOR REGISTRATION

All persons registering as a company director, regardless of the size of the business, will be required to complete a director's registration program, which will be completed online and based on a directors handbook, which is focused on basic business principles and obligations under the *Corporations Act.*

The registration would apply to all new director appointments and provide a three year period for existing directors to register. ASIC will provide electronic alerts (normally via email) to all registered directors with information updates on a regular basis, or as critical parts of the law are changed. Any person advising a business operating under the moratorium provisions envisaged under Recommendation 1 above, will also need to be a registered director. A registration fee will apply to cover the costs of the registration and training program.

3.2 Australian Securities and Investment Commission

The Australian Securities and Investment Commission (ASIC) is responsible for the administration of the *Corporations Act*. The *Corporations Act* details the responsibilities of directors and the role, function and rights of voluntary administrators, liquidators and receivers. ASIC has a division dedicated to Insolvency Practitioners, Accountants and Auditors.

[29] Australian Securities and Investments Commission, *ASIC Annual Report 2008-09* (2009) 3.

ASIC's most recent annual report, for the period 2008-09, dedicates four pages to highlighting its "major enforcements"[30]. Interestingly, Stuart Ariff gets a billing, however there is no mention of the $5 million in damages to clients/creditors that has failed to materialise[31]. Over the year, ASIC is proud to have achieved 18 convictions and 8 suspended sentences.[32] During 2009 (up until the end of November) there were 8,728 voluntary administrations entered by Australian companies and 13,498 insolvency appointments. ASIC estimates that insolvency practitioner complaints account for less than 2% of total complaints and breach notifications.[33] It seems ASIC is implying that there are no systemic issues to be considered in the insolvency industry. However 2% of all complaints in the 2008-09 period amounts to 273 complaints. This is significant when considering there are only 576 practising liquidators. Ferguson provides an interesting perspective:

> ASIC estimates that insolvency practitioner complaints account for less than 2 percent of total complaints and breach notifications. At face value this might seem small, but given that there are only 576 practising liquidators in the country and ASIC monitors more than 1 million companies, thousand of licensed financial service operators, market conduct and the role of directors, the more obvious conclusion is we have a systemic problem that needs to be addressed.
>
> But we can't know because ASIC does not disclose whether it is spending more or less time investigating complaints against liquidators. Nor does it calculate an investigation referral rate specifically for insolvency practitioner complaints, or which go into a formal investigation. …. And those cases that ASIC deems worthy of taking action on, it too often refers them to the Companies Auditors and

[30] Ibid, at 16-19.
[31] Ibid, at 17.
[32] Ibid, at 18.
[33] ASIC, *2009 Insolvency Statistics* (2009) Australian Securities and Investment Commission <http://www.asic.gov.au/asic/asic.nsf/byheadline/2009+insolvency+statistics?openDocument > at 18 January 2010.

> Liquidators Disciplinary Board (CALDB), which has the power to suspend an offender for a year.[34]

ASIC can obviously exercise considerable discretion as to which complaints it follows through to an investigation. So even if the volume of investigations were known, the number not investigated, or referred to the CALDB is not provided. In 2008-09 ASIC expended $148 million (just over 50% of total expenditure) on 'enforcement activity to give effect to the laws administered by ASIC.'[35] In 2007-08 ASIC received 11,436 reported crimes and misconduct submissions, compared with 10,682 in the previous year[36]. For 2008-09 this number increased to 13,633. The trend of increasing complaints is obvious. ASIC indicates in the 2008-09 report that 70% of these complaints are 'finalised in 28 days' (in accordance with ASIC policy). However, where a complaint remains, ASIC will not indicate whether it is formally investigating the complaint. Given the trend in complaint numbers, ASIC will argue that it simply doesn't have the resources to investigate the high number of complaints.

This is supported by ASIC's website where it states:

> **Generally we do not act for individual complaints and we will seek to take action only on those reports of misconduct or breaches of the corporations law that will result in a greater impact in the market and benefit the general public more broadly**.[37]

This must have been enticing encouragement to the likes of Ariff. Complaints about Ariff were being made in 2005 and complainants received no constructive response from ASIC until some two years later. That is two years after Joel Fitzgibbon called on ASIC in the

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[34] Adele Ferguson, *Senate Probe bodes badly for ASIC* (2009) The Age Business Day <http://www.theage.com.au/business/senate-probe-bodes-badly-for-asic-20091129-jyy1.html> at 18 January 2010.
The Board has no statutory power to initiate or carry out investigations into the conduct of auditors or liquidators. The role of the Board is to deal with Applications made by ASIC or APRA.
[35] 'ASIC Annual Report 2008-09', above n.27 at 11.
[36] Adele Ferguson, *Watchdog a wimp in Ariff tiff* (2009) The Australian Online <http://www.theaustralian.com.au/news/watchdog-a-wimp-in-ariff-tiff/story-0-1225757245238 > at 21 January 2010.
[37] 'How ASIC deals with your complaints', above n.12.

Federal parliament to act. If a federal politician cannot get traction, what hope is there for a small business operator?

In fact the structure of the private sector means that they are abandoned by ASIC's greater market impact philosophy. Remember, there are approximately two million businesses in the Australian economy, of which 228,000 (11%) have 5-20 employees, while 1.7 million, representing 85 percent of the private sector employ less than four people[38]. ASIC's approach and underlying philosophy must change. Given the relative number of firms by size, then the overwhelming majority of administrations and insolvencies will be small owner operated businesses, with limited wherewithal, or resources, to take on a rogue administrator. ASIC will argue it is not possible to resource such an approach. However, in 2008-09 ASIC generated $552 million 'for the Commonwealth in fees and charges' and expended $295 million in the discourse of its regulatory role[39]. This leaves a contribution to consolidated revenue of $257 million (47% of gross revenue). More resources are possible.

As recently as 28th January Minister Bowen announced changes to ASIC's powers, increasing their capacity to investigate and to charge penalties. But as Ferguson (2009C) indicates:

> ASIC has lots of powers. Under section 19 it can require a person to appear under oath for examination and answer whatever questions will help in its investigations. An examinee is not entitled to refuse to give information on the basis that doing so might incriminate them, although this information may not be used in criminal prosecution or proceeding to impose a penalty. Nor is ASIC required to tell the examinee in advance the questions he or she will be asked. [40]

There is a certain irony around the recent statements made on the 27 January 2010 by the chairman of ASIC, Tony D'Aloisio, that: 'We have taken the view that it is our job as the

[38] Australian Bureau of Statistics, *Counts of Australian Business, Including Entries and Exits*, (2007) 18.
[39] 'ASIC Annual Report 2008-09', above n.27 at 10.
[40] Ferguson, 'Watchdog a wimp', above n.34.

regulator to push the regulatory regime to the limit.' In this respect, the corporate regulator has 'put boards on notice that it will pursue a vigorous campaign against company directors for breaching their duties this year.' [41] It seems ASIC is flexing its regulatory muscle, perhaps to distract attention from their recent failed show trials (for example, the case against One.tel founder Jodee Rich and executive Mark Silberman- estimated to have cost more than $20 million – and resulting in judicial criticism of the regulator for exaggerating the facts and running a superficial case; also the Federal Court in Perth dismissed proceedings brought by ASIC – which according to some reports also cost $20 million – that claimed Fortescue Metals and billionaire Andrew Forrest had misled investors).[42]The estimated $40 million spent on these two cases (which doesn't include the $13.8 million to cover Jodee Rich's legal costs[43]) could have dealt with a lot of complaints against administrators who have acted like Ariff and would have signalled a "vigorous" pursuit of rogue operators in the insolvency industry.

Instead of educating directors (see Recommendation 4 above), ASIC are going to penalise breaches of duties with more vigour. ASIC should treat the private sector with a greater degree of equity. The shareholders and creditors of large companies usually have diversified investments, or a broad range of clients. Small firm owners tend to have one investment, their business, and when this is taken from them, the impact is far greater than the loss of one shareholding in an investment portfolio.

Currently co-operatives and some not-for-profits are excluded from the *Corporations Act*. This needs to be amended as they often fall between the regulatory cracks, which is

[41] Ibid, at 10.
[42] Ibid.
[43] Susannah Moran, 'One-Tel boss to get $13m costs from ASIC' *Weekend Australian* (Sydney) 6-7 February 2010, 3.

highlighted in the recent case of Adamstown Rosebud Sport and Recreation Club (another Ariff victim) summarised recently by Joanne McCarthy[44].

In Ariff's case, he allowed his professional indemnity and fidelity insurances to lapse. Rather than a formal recommendation (and to foster brevity) it is obvious that where an insolvency practitioner has a current policy with an insurer and that lapses or is not renewed, the insurer should be required to notify ASIC and ASIC required to ensure they have current insurances through appropriate inquiry.

RECOMMENDATION 5 – SMALL AND MEDIUM SIZED FIRM FOCUS

ASIC establish a division which focuses on small and medium sized firms, not just in terms of complaints made about accountants and insolvency practitioners; to assist them in complying with the *Corporations Act*; to educate them with respect to business decision making; and the role of corporate directors. The voluntary administration and insolvency provisions of the *Corporations Act* should be extended to include not-for-profits and co-operatives.

RECOMMENDATION 6 – TRANSPARENT RESPONSES TO COMPLAINTS

Where ASIC is investigating a complaint, ASIC should notify the complainant that they are reviewing the matter. At the conclusion of the review, they should indicate whether the review resulted in action on the part of ASIC, and if it did not result in any action, the basis for the decision. The greater impact in the market test currently applied by ASIC, in acting on complaints, is detrimental to small business and should be revoked, or reinterpreted to include the impact on the overwhelming number of entities in the private sector (which are essential to economic development). ASIC should also provide statistics in its annual report relating to the number of complaints they investigate by size of business.

3.3 Professional Bodies

The role of professional bodies, in particular the accounting bodies, being the Chartered Accountants (CA), National Institute of Accountants (NIA) and the Chartered Practising Accountants (CPA), along with the Insolvency Practitioners Association (IPA), in regulating, investigating and reporting on inappropriate professional behaviour needs to be reviewed. An independent inquiry into the expected response, when a member breaches their professional, or legal responsibilities should be commissioned, including consideration of the role and benefit of such associations.

The CA's refused to investigate Ariff while the *Wambo Coal* case was before the court. This raises the questions: What is an effective role for such a body as the assumed gatekeeper on quality in the profession? Further, why didn't they investigate complaints that weren't before the courts? These professional bodies need to be **required** to investigate and report on complaints.

In theory, such professional bodies exist to give the members a standing in the community and to ensure the maintenance of an exemplary standard of professional and ethical conduct at all times. This standing in the community is special and the professional bodies should ensure that it is honoured and protected. It is these standards that allow them to charge professional fees and to input into corporate and professional development. Where a complaint is made about a member's behaviour, it should be fully investigated and the appropriate action taken to punish those found to have breached their duty as a member. They should not be reactionary, waiting for courts or regulators to investigate. If this is the standard approach, then they are not functioning as expected by society and their special standing should be withdrawn. One might go as far to argue that they have no purpose if they cannot, or display a degree of reluctance to, investigate and ensure the highest standards.

The IPA has limited, if any, capacity to investigate complaints made about members. It does have an extensive code of professional practice. However, member compliance with the standards and codes cannot be mandated, which is ironic, given they are regularly referred to by regulators and the courts. This needs to be addressed. The IPA's will refer complaints to the CA's, CPA etc; however, it seems that the mode of operation of these bodies, is to refer on the complaint to the regulator, or wait for the outcomes of legal action. This assumes the regulator will act, when often they do not.

RECOMMENDATION 7 – THE ROLE OF PROFESSIONAL BODIES

The regulator needs to clearly define the role of the professional bodies, in investigating, reporting and sanctioning members, subject to complaint. A response from the professional bodies, along similar lines to Recommendation 6 should be required within the corporations and related law.

4. SUMMARY OF RECOMMENDATIONS

RECOMMENDATION 1 – WORK OUT OPTION:

The elements of the extended business judgement rule and the moratorium option proposed in the Commonwealth Governments discussion paper: Insolvent trading: A safe harbour for re-organization attempts outside of external administration (January 2010) be implemented through changes to the *Corporations Act*.

RECOMMENDATION 2A - ESTABLISHING A BASELINE VALUE:

On appointment the owners are required to provide all business records and property. At this point (and within a reasonable time) the VA should provide a "baseline value" for the business, including the value of all material assets. This should be provided to all creditors as part of the VA process, whether the recommendation is a deed of arrangement or liquidation. This document should be reviewed by an independent VA and all values for material assets certified by an accredited industry valuer. If in the course of the administration the VA seeks to dispose of any material asset and the disposal value is less than 20% of the valuation, then a formal creditors meeting is required before any such disposal can be effected.

RECOMMENDATION 2B - REGISTRATION OF PROXIES:

Proxies should be lodged with an independent third party agreed by the creditors. The proxies are only valid on a meeting by meeting basis and the VA is not informed in advance as to the level of proxies held by the third party.

RECOMMENDATION 3: APPROVED APPOINTMENTS:

At a minimum, the bona fides of all such appointments should be approved by the creditors (applying the 75% majority approach outlined in Section 3.1.1). This could be achieved by way of flying minute (email) including the resume and experience of all such appointments.

RECOMMENDATION 4 - DIRECTOR REGISTRATION:

All persons registering as a company director, regardless of the size of the business, will be required to complete a director's registration program, which will be completed online and based on a directors handbook, which is focused on basic business principles and obligations under the *Corporations Act.*

RECOMMENDATION 5 – SMALL AND MEDIUM SIZED FIRM FOCUS:

ASIC establish a division which focuses on small and medium sized firms, not just in terms of complaints made about accountants and insolvency practitioners; to assist them in complying with the *Corporations Act*; to educate them with respect to business decision making; and the role of corporate directors. The voluntary administration and insolvency provisions of the *Corporations Act* should be extended to include not-for-profits and co-operatives.

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