ACF
AUSTRALIAN CREDIT FORUM

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Parliamentary Joint Committee on Corporations and Financial Services
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Parliament House
Canberra ACT 2600

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Dear Sir/Madam

Submissions to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into corporate insolvency in Australia

The Australian Credit Forum (**ACF**) welcomes the opportunity to make a further submission to the Australian Government in respect of the effectiveness and potential reforms to corporate insolvency in Australia following their appearance at the Parliamentary joint committee on corporations and financial services – Corporate Insolvency in Australia on Tuesday 28 February 2023.

Who are the ACF?

The ACF was established in the early 1970's by a group of senior credit professionals. The group recognised the need to develop an association where members could meet on a regular basis to exchange thoughts and ideas to strengthen their own knowledge but also the standards of the industry.

The association meets on a regular basis to discuss and review existing and proposed changes to the Federal and State Governments legislation that might have an impact on their company's credit policies and practices in their day-to-day role as credit professionals.

The members of ACF are drawn from all areas of the credit profession across a range of industry groups including but not limited to senior credit managers, members of the legal profession, insolvency practitioners, credit insurance underwriters and brokers, mercantile agents and credit reporting agencies. The depth and diversity in experience of the members ensures that a broad cross section of the credit industry considers the impact of all relevant legislation.

Further submissions

The ACF addresses the following additional matters in the further submissions as a result of questions taken on notice during the inquiry.

1. Unfair preference regime and recommendations for change.

2. Simplification of insolvency and impact of current framework on creditors.

3. Recent developments in case law regarding unfair preferences.

The ACF appeared with the Australian Institute of Credit Management (**AICM**) and has worked in collaboration regarding these further submissions, and the submissions made on behalf of the AICM.

The ACF endorses the further submissions of the AICM.

Part 1 - Unfair Preference Regime and recommendation for change

Unfair preference claims have always been a source of pain and frustration for trade creditors.

Under the current regime businesses are unfairly penalised for having effective credit management processes and for being proactive in their engagement and management of their customer's financial position and day to day needs.

It is a very common practice for trade creditors to provide credit to businesses when other financial institutions will not afford the same level of financial support.

From the time in which an insolvency practitioner is appointed to a company, trade creditors are forced to respond to preference claims made against them which are not well considered and at times made only in an attempt to recover fees incurred in the liquidation by insolvency practitioners and their representatives.

It is rare in practice that we see funds redistributed to unsecured creditors in external administrations.

In the interest of achieving clarity, eliminating the impacts of preference claims on efficient trade and minimising the impacts on insolvency on creditors we recommend that preference claims are not pursued at all against unrelated creditors.

It follows that the ACF submits that the unfair preferences against unrelated creditors should be abolished in totality.

In the event this is not possible, as an alternative or interim step, we recommend amending suspicion to actual knowledge of insolvency, implementing a threshold below which claims can't be brought, reducing the relation back period and reducing the time frame when claims can be made on creditors. However, we note that these alternative/interim steps will still leave room for manipulation, poor practices and unfair outcomes for creditors.

These elements are discussed further below.

<u>*Actual knowledge v suspicion*</u>

Members of the ACF and their respective credit and finance teams regularly engage in customer focused initiatives to facilitate payment of outstanding accounts. In working with their customers members of the ACF are able to proactively manage, facilitate payment of overdue amounts and drive growth with respect to retention and future sales.

This support is not only important to the trade creditor but critical to the growth and ongoing trade of the customer themselves.

Trade creditors are encouraged to support businesses with ongoing trade at times where they may be early indicators of insolvency. This support is provided through the course of everyday dealings with their customers. When traditional finance may not be an option the trade creditor is critical to the eco system and survival of the business.

A member of the ACF states:

" I have a fairly large team, and 14 of those team members are employed to make outbound calls, they work directly with customers, including around payment of their accounts. Our customers are principally electricians and trades people, some small, some medium and some grown to be quite large, but at the end of the day, their core expertise is their trade, and they dislike the admin side of

the work they do. If we don't engage with them around paying their accounts on time, or at all then they won't bother chasing their own customers so feeling a little bit of pressure is not a bad thing because it spurs them into action."

As a result of the recent decision of *Metal Manufactures Pty Limited v Morton* [2023] HCA 1 (**Morton**) trade creditors have only a few defences or strategies available to defend an unfair preference claim.

These defences include good faith defence, the application of the running account and the defence is founded on the premise of the creditor being secured.

The good faith defence both in practice and before the court is difficult to run and hard to maintain.

The ACF submits that the indicia usually relied upon, are simply everyday practices of good credit management and that the members of various credit and finance teams would not know or have any knowledge of the actual solvency of their customers.

Section 588FG of the Corporations Act 2001 (**Corporations Act**) provides that:

"Transaction not voidable as against certain persons

If no benefit or benefit received in good faith without grounds for suspecting insolvency

(1) A court is not to make under section 588FF an order materially prejudicing a right or interest of a person other than a party to the transaction if it is proved that:

(a) the person received no benefit because of the transaction; or

(b) in relation to each benefit that the person received because of the transaction:

(i) the person received the benefit in good faith; and

(ii) at the time when the person received the benefit:

(A) the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent as mentioned in paragraph 588FC(b); and

(B) a reasonable person in the person's circumstances would have had no such grounds for so suspecting…"

It is the ACF's recommendation that amendments be made to the Corporations Act, specifically section 588FG to adopt a position of actual knowledge as distinct from suspicion.

Under the current regime the suspicion of insolvency is extremely unfair. Unrelated creditors should not be punished when it is impossible to agree on what is suspicion and secondly defend something as vague as suspicion.

If there is an amendment to actual knowledge, rather than suspicion and the framework which sits around this better defined, preference action taken against creditors will be more certain and less complex.

An alternate approach to amending the Corporations Act to actual insolvency could be adopting a framework that this similar to that of the United Kingdom. The framework in the United Kingdom provides that the key difference is that the payment must have been made with the *"requisite desire to place the recipient in a better position that they would otherwise be in on the debtor's insolvency"*

This framework requires proof that the company was actively "preferencing" a creditor. In proving this intent of the company, pressure brought on through normal collections activities cannot be an indicia of the company desiring to preference the creditor.

On its current drafting it is harder for a creditor to make out a good faith defence to an unfair preference than it is for a director to defend an insolvent trading claim.

There is no definition of insolvency in the Corporations Act, just that solvency is able to pay debts as and when they fall due. The mere fact that insolvency is not defined calls into question how the suspicion of insolvency can be the measure with respect to insolvency because it is not clear what the definition of insolvency is. This is problematic and confusing.

The ACF submits that an inclusion of a definition of insolvency will bring about greater clarity and certainty to the regime and the impact of the Corporations Act.

Readjustment of timeframe to clawback period for an alleged unfair preference claim

It is the ACF's submission that the time period that a liquidator has to claw back and alleged preferential payment against a creditor is too long and should be reduced to three months akin to the time imposed in a simplified liquidation.

Reduction of the time period an insolvency practitioner has to commence proceedings against a creditor to recover an alleged preferential claim

Three years in practical terms is an abuse of process.

Regularly in practice and through the experience of the members, we see preference activity only initiated near the final months of the three-year period. This often results in legal proceedings being commenced which are not properly considered and claims made without proper substantiation.

Further extension to this is the regular occurrence of applications being made to extend the time to commence proceedings. It is the ACF's submission that this is clearly an abuse of process.

In a recent matter one of the ACF's members was being pursed for a claim for $89,537.10.

Proceedings had been commenced by a liquidator filed one month before limitation period after failing to respond to substantiation letter a couple of weeks earlier.

Prior to commencing the action there had been a failure of the liquidator to consider running account. Following the commencement of the action it was plain that the liquidator had no claim. After a defence was filed, the proceedings were then discontinued.

Had proper investigations been undertaken it is likely that the proceedings would not have been commenced as there was no basis for a claim.

The member incurred $6,000 of costs in dealing with a claim that should never have been brought.

It is the ACF's submission that this example is one of many, and that is it regular and common practice to see proceedings commenced against a creditor just before the expiry of the limitation period.

It is the ACF's view that this practice is of no benefit to creditors of the liquidation and results in increased and unnecessary costs being incurred.

Unfair preference action should not be issued unless the claims are properly considered by the insolvency practitioner

In practice members of the ACF believe that unfair preference actions are often commenced without consideration of the actual merits of the claim being made. The ACF believes that this practice is driven by a need for insolvency practitioners and their representatives to recover fees spent in administering the liquidation.

A member of the ACF was recently involved in an unfair preference claim where they were being pursued for the sum of $28,298.89.

Despite responding to the demand proactively a resolution pre litigation could not be reached and proceedings were commenced.

The member was able to make out all the usual defences and this was foreshadowed in the initial prelitigation correspondence.

Prior to the member taking steps to file its defence, an offer of $3,000 was made on the basis that the member had good faith defence available, they were able to apply the running account and at that time we at the time the member was also able to claim a set off in the amount of $8,000.

The liquidator refused to accept the application of the running account and the member was forced to file defence in April.

The matter fell away in June when a walkaway offer was issued and accepted.

The member spent approximately $8,500 in dealing with matter. There was no recovery from the liquidator. Again, in this matter the proceedings should never have been commenced.

If the claim had been properly considered from the beginning proceedings and a proper assessment undertaken, it would have been clear that the matter was uncommercial to run and the claim itself had no merit.

In another matter a member received a demand for $6,800. Not only did the member question the merits in proceeding with the action, but there was also a large question over the commerciality and subsequent benefit to the liquidation and creditors in running such an action.

Upon receipt of the initial demand in 2020 the members' representatives responded seeking substantiation of claim.

In 2021 the liquidator engaged solicitors to respond and provide documentation. The member then responded raising issues regarding insolvency and commerciality of proceeding against our client for $6,800. No settlement offer was made.

In October 2022 the member received a further demand and a draft statement of claim. Despite settlement discussions on foot the member was then joined to mothership proceedings. The member is still involved in the mothership proceedings and continues to incur costs in defending this claim.

The ACF submits that this type of practice is extremely questionable and highly uncommercial. There is no foreseeable benefit to the liquidation and to creditors of the liquidation in running an against a creditor for $6,800.

This is just one example of small demands being made against creditors in relation to unfair preferences.

The ACF submits that if action is to be taken against a creditor for an unfair preference there should be a threshold, and action should not be taken for anything under $30,000.

Prosecution of unfair preference claims requires a regulated framework

It is the ACF's submission that the current practice of insolvency practitioners and their legal practitioners commencing legal action against creditors on a speculative basis should be regulated and operate within a specific framework.

Firms (both insolvency and legal) practicing on a speculative basis whereby fees are not payable until the obtainment of a successful recovery increase the appetite for running unfair preference matters which would commercially not have been run but for the liquidators attempt to recover already incurred fees.

The interest in which both liquidator and law firm running the action are pushing and protecting are not those of the creditor and the interest moves to that of the recovery of fees as opposed to what is in the best interests of the Company and its creditors.

It is the ACF's submission that this type of activity is rampant within Australia and when reviewing the numbers of matter which have involved members there appears to rarely any benefit to creditors in the liquidation.

It is extremely uncommon for any funds recovered from creditors to be distributed back to the pool of creditors.

To prevent this practice, it is the ACF's submission that legal action against unrelated creditors should not be able to proceed on a speculative basis.

Further and in the alternative if it is not completely abolished there should be greater requirements on insolvency practitioners and their legal representatives to disclose the type of activity to the creditors of the liquidation and the merits or prospects of the alleged claim should be considered in the first instance to ensure that it is of benefit to the creditors of the liquidation.

Part 2 - Simplification of insolvency and impact of current framework on creditors

It is the ACF submission that through simplification of insolvency laws and processes better outcomes can be achieved for creditors.

In speaking with insolvency practitioners and more specifically those involved with the ACF it is apparent that upon appointment a significant amount of time is spent dealing with matters relating to the Personal Property Securities Act 2009 (**PPSA**).

One of the material aspects of complexity in relation to the administration of an external administration appointment is the process required to be undertaken by an administrator/liquidator upon their appointment to a company with a substantial number of Purchase Money Security Interest (**PMSI**) creditors.

In a recent administration appointment involving two members there were 17 PMSI registrations with the majority of those registered by suppliers who had supplied goods to the company on credit terms.

The insolvency practitioner was required to undertake the following actions upon appointment.

1. Conduct a stocktake, with the assistance of a licensed valuer, of all the stock located at the company premises to ensure an accurate count of all supplied goods could be compiled and identified upon their appointment.

2. Within the first day of the appointment, the insolvency practitioner had to write to each PMSI creditor, requesting the provision of the relevant parties' terms of trade, credit agreements, outstanding invoices, consider each of the registration's validity, seek legal advice to ensure their views on the security validity were correct post receipt of the relevant documents from the security holder.

3. The insolvency practitioner then had to reject those claims that weren't valid and where goods vested in the company upon appointment.

4. The insolvency practitioner then had to enter an arrangement with the landlord to maintain possession of the premises whilst this process was being undertaken, whilst completing the other duties required as administrator.

5. Lastly the insolvency practitioner had to arrange with each supplier a time to attend the premises, meet with the supplier's representative to identify each item on each outstanding invoices, confirm that the items matched and weren't subject to any other security claim by other creditors.

For 17 different parties, this process took over a week to complete.

The costs incurred in relation to this process amounted to approximately 40% of the time charges incurred during the administration portion of the appointment. The practitioner was required to seek legal advice which added an additional cost impost and whilst it resulted in the majority of the PMSI creditors receiving some stock back under their security arrangements, the majority of those costs were borne by the unsecured creditor group.

The complexity of the PPSA, and the legal requirements to ensure registrations are valid, especially with the potential added complexity of company's acting in their capacity as trustees of trusts are areas where simplification would be useful so as to decrease the costs to creditors, and the complexities faced by external administrators, in attempting to get a return to the overall creditor pool.

This is a common occurrence.

The ACF submits that a solution may be that at the point of registration and prior to a grantor granting the security interest that the interest is verified. This initial verification would reduce the time spent in verifying and validating the interest by an insolvency practitioner.

The general objective of the PPSA and its utilisation by creditors is beneficial and it has ultimately achieved its purpose. However, there is a huge opportunity to improve the PPSA to simplify its process and ensure that it is being utilised for the very objective for which it was created.

The complicated law and process is a true and real cost to creditors.

Simplification of trusts – trusts with corporate trustees

ACF's view is that corporate insolvency framework should be amended to provide for the external administration of insolvent trusts with corporate trustees.

The current framework has been historically problematic for creditors and does not adequately cover how business trust structures and businesses proceed with an insolvency event.

Practically speaking there is little transparency with respect to trusts generally in dealing with business and the ACF fully supports the position of a trust register to identify exactly sits behind trust structures when dealing with trust entities.

It is a common problem for many businesses and members of the ACF where they trade and provide credit to a particular entity believing they are dealing with the corporate structure only to discover later on that there is a trust structure in place and that the corporate structure is simply the trustee of a trust.

Frequently, when members look to enforce an equitable charge which is derived from a credit agreement over property held on a corporate trust and/or individual basis, it is established that the property itself is owned by the trust and that the trustee is simply holding this property on trust.

Noting the issues with land registers and transparency as the true ownership of property, creditors are often supplying credit to what they believe to be the final entity to discover there is trust setup.

A trust register would help reduce this issue and provide greater transparency for creditors and credit professionals when providing credit.

ACF's view is that legislation needs to be amended to assist with the winding up process of trusts like that of a company. This will reduce in costs which are incurred in the liquidation.

The ambiguous position of the treatment of trusts and their assets, in circumstances where a company that has acted in the capacity of the trustee of a trust and then proceeds to enter a formal insolvency appointment is an area that needs reform.

There is no certainty for suppliers/credit providers who are engaging in businesses with company's acting in this capacity as it may not be disclosed at the time of applying for and/or granting credit terms or it may come into effect post application.

Upon the formal insolvency appointment, the trustee company is in most circumstances automatically removed from its position as trustee of the trust by way of the operation of the trust deed and the assets held in the trust are then out of the reach of the liquidator appointed, and creditors.

Whilst there is a right of indemnity between the trustee company and the trust, at law, it is often costly to try and enforce and in lots of circumstances, not commercial to pursue as the trustee company is often without funds at the time an appointment, by way of the operation of the trust deed.

An ACF member has currently been appointed to a company, which only ever operated in its capacity as trustee of two different trusts and this position was, as is often the case, severed by the operation of the trust deeds, upon their appointment to the trustee company.

The trusts hold significant assets, and the practitioner is now forced to make an application to the court to be appointed as receiver over those trust assets, which is likely to be contested.

The advice, application, legals and liquidator's costs to make the application are estimated to be approximately $70,000. This cost to the liquidation and ultimately cost to creditors could be overcome with the law and processes being simplified.

Delinquent directors and related parties of companies in liquidation

Under the Corporations Act, directors and certain parties are required to provide information and comply with directions given by a liquidator to assist with the winding-up of a company.

Without being exhaustive, the Corporations Act requires that:

1. directors submit a report as to the company's affairs (**RATA**) under section 475 of the Corporations Act, usually within 10 business days after the winding up of a company;

2. directors provide assistance for the proper conduct of the winding up of a company as a liquidator reasonably requires under section 530A of the Corporations Act, in support of a liquidator's efforts to take control of company property; and

3. parties to deliver books and records of a company that are in their possession to a liquidator, under section 530A of the Corporations Act.

The following case studies illustrate the difficulties liquidators have faced in dealing with recalcitrant directors of companies, which often results in prejudice to creditors (directly and indirectly) due to undue delays and increased costs and expenses in the liquidation.

Example - Unjustified delays by a director in submitting a RATA.

By way of an example a member experienced unjustified delays of over three months by a director in submitting a RATA, where no reasonable excuse was provided.

In such circumstances, the recourse available to a liquidator to compel compliance is limited to:

1. preparing a report of non-compliance and notifying ASIC, with the view that compliance action/proceedings are undertaken by ASIC (with little assurances such action would be pursued); and

2. the commencement of enforcement proceedings by the liquidator under section 534 of the Act.

Example - Director's unwillingness to assist the liquidator's efforts to take control of company assets and provide the location and status of company books and records.

By way of example in another recent matter which a member was a creditor over four months have elapsed since the liquidator's request under sections 530A and 530B was issued to the director regarding the assets, books and records of the company.

The director has been delinquent in responding to those requests and has acted in a manner that is obstructive towards the liquidation process, including by:

1. refusing to deliver up company property;

2. refusing to deliver up company books and records;

3. refusing to provide assistance to the liquidator regarding the location and status of company books and records and property; and

4. concealing property that could potentially form part of the assets of the company by moving them onto the director's private premises to hinder the liquidator's investigations.

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In such circumstances, the recourse available to a liquidator to compel compliance is limited to:

1. preparing a report of non-compliance and notifying ASIC, with the view that compliance action/proceedings are undertaken by ASIC (with little assurances such action would be pursued); and

2. filing an application for a search and seizure warrant under section 530C; and

3. filing an application for public examination under part 5.9.

The ACF submits that this process should be reviewed to widen the scope to compel compliance.

As demonstrated above, there is little incentive for the directors to comply with requests/directions from liquidators given the lack of hard and real consequences for non-compliance. This is especially true in circumstances where funds in the liquidation are limited.

The liquidator, in order to properly comply with its statutory duties, often incurs costs to compel compliance where prospects for recoverability on behalf of creditors is low.

While the Assetless Administration Fund (**AA Fund**) does provide some assistance and resources in the liquidation process, it is often insufficient for liquidators to properly finalise the investigative work required of them, particularly if court proceedings are involved and require the liquidator to retain solicitors and barristers to properly prosecute those claims.

The robust reforms as a result of the Harmer Report have shifted the objective of insolvency laws from being punitive to one that is rehabilitative with a focus on protecting the rights of creditors. The ACF submits that such an approach to insolvency laws has been beneficial in promoting enterprise and business innovation in Australia. However, there is a need for a review of the practical operations of the Act as well as the effectiveness of ASIC's regulatory powers including the adequacy of the AA Fund in promoting the policy objectives of the insolvency laws.

This is notably so in light of the current economic climate caused by recent unprecedented global events which are likely to result in an increase in the number of external administrations and corporate insolvencies in the medium to long term.

Part 3 - Recent developments in case law regarding unfair preferences.

The High Court decisions of Morton and *Bryant v Badenoch Integrated Logging Pty Ltd* [2023] HCA 2 (**Badenoch**) put an end to the debate by rejecting the applicability of the set-off defence and peak-indebtedness rule.

Section 553C of the Corporations Act provides for an automatic set-off where there are mutual credits, debts or dealings between a creditor and an insolvent company.

Prior to the *Morton*, creditors facing unfair preference claims would raise a set-off as a defence to an unfair preference claim if the creditor was still owed a debt by the insolvent company.

The High Court unanimously held in favour of the liquidator in Morton that it is not permissible for creditor to raise a set-off under section 553C of the Corporations Act in defence to an unfair preference claim.

While the ACF understands the reasoning behind this decision it is disappointed that an additional defence has been taken away when responding to and dealing with unfair preference actions.

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The ACF welcomed the decision in Badenoch. With the peak indebtedness rule being abolished it the ACF believes that the quantum of preference claims being issued will be reduced and we will see greater consideration of the trading relationship by insolvency practitioners.

It is the ACF's view that if unfair preference action is to remain in place, then there should be greater certainty and clarity to the defences available. This should be prescribed further in legislation.

Summary

The ACF welcomes the opportunity to meet and discuss further the matters addressed in these submissions and are willing and able to provide further examples upon request.

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Anna Taylor
Chairman - Legislative Sub-Committee
Australian Credit Forum