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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Australia's insolvency laws

THURSDAY, 14 AUGUST 2003

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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Thursday, 14 August 2003

Members: Senator Chapman *(Chair)*, Senator Wong *(Deputy Chair)*, Senators Brandis, Conroy and Murray, and Mr Byrne, Mr Ciobo, Mr Griffin, Mr Hunt and Mr McArthur

Senators and members in attendance: Senators Chapman, Brandis and Murray, and Mr Griffin

Terms of reference for the inquiry:

To inquire into and report on:

The operation of Australia's insolvency and voluntary administration laws, including:

(a) the appointment, removal and functions of administrators and liquidators;

(b) the duties of directors;

(c) the rights of creditors;

(d) the cost of external administrations;

(e) the treatment of employee entitlements;

(f) the reporting and consequences of suspected breaches of the *Corporations Act 2001*;

(g) compliance with, and effectiveness of, deeds of company arrangement; and

(h) whether special provision should be made regarding the use of phoenix companies.

WITNESSES

Committee met at 4.38 p.m.

CLARKE, Mr Jon, Chair, Insolvency and Reconstruction Committee, Business Law Section, Law Council of Australia

GOODE, Mr Andrew Britten, President, Law Society of South Australia, Law Council of Australia

GOTTERSON, Mr Robert William, QC, President-elect, Law Council of Australia

GREENTREE-WHITE, Mr James Russell, Lawyer, Legal and Policy, Law Council of Australia

MELLICK, Ms Kate, Lawyer, Legal and Policy, Law Council of Australia

CHAIRMAN—Today the committee continues the public hearings of its inquiry into Australia's insolvency laws. Before we commence taking evidence, I reinforce for the record that this is a hearing in which all witnesses appearing before the committee are protected by parliamentary privilege with respect to the evidence provided. Parliamentary privilege refers to the special immunities and rights attached to the parliament, its members and others, necessary for the discharge of parliamentary functions without obstruction or fear of prosecution. Any act by any person which operates to the disadvantage of a witness on account of evidence given by him or her before the parliament or any of its committees is treated as a breach of privilege. I also state that, unless the committee should decide otherwise, this is a public hearing. As such, all members of the public are welcome to attend. I now welcome the representatives of the Law Council of Australia to the hearing.

As I mentioned, this is a public hearing and hence the committee prefers that all evidence be given in public but if, at any stage of your evidence or answers to questions, you wish to give evidence in private, you may request that of the committee and we will consider such a request to move to in camera. The committee has before it the written submission from the Law Council of Australia, which we have numbered 26. Are there any alterations or additions you would like to make to your written submission at this stage?

Mr Gotterson—Not to the written document, thank you.

CHAIRMAN—I invite you to make opening statements, at the conclusion of which committee members will ask questions.

Mr Gotterson—The Law Council very much appreciates the opportunity to appear today before the parliamentary joint committee. It is an opportunity, welcomed by us, to outline our views in relation to a number of important aspects of Australia's insolvency laws. The committee is now aware of those who have accompanied me today. We propose that I should make an opening address, and those with me will participate in response to questions that will come up.

From our perspective this whole inquiry affords a great opportunity to enhance the content and operation of the insolvency laws in Australia. It could be said that, apart from one major change, the reforms that we seek are in the nature of finetuning. Let me turn to the major change, which

is in relation to the qualification requirements for registered and official liquidators. Our proposal is that the requirements for registration of liquidators be amended to broaden the categories of individuals who are eligible to be liquidators. I intend to speak about this proposal first before turning to our other recommendations.

To begin with the current law on the topic, section 1282 of the Corporations Act provides that ASIC must register a person as a liquidator if the person satisfies certain requirements which are set out in the section. There are three requirements I will mention. The first one is that membership of certain professional bodies of accountants or tertiary qualifications in accountancy and commercial law be attained. The professional bodies of accountants that qualify here are set out in section 1282 of the Corporations Act. So that is the first requirement: membership of the bodies or tertiary qualifications in accountancy and commercial law. The second requirement is experience in connection with winding up corporations. The third requirement is a capability requirement: that the person is a fit and proper person to be a liquidator as well as being capable.

Those three requirements are cumulative; they are not alternatives. They underlie a registration system for liquidators. We strongly support that there be a registration system for liquidators. From our perspective, entry requirements are necessary to protect the public from unqualified practitioners. Our point is, however, that the current entry requirements are too restrictive. It is not only our point; it is a point that has been made in the past by the Trade Practices Commission, by an ALRC inquiry and by a working group, and I will refer to what they had to say in due course.

But the respects in which the requirements are too restrictive fall into two types. The first is the insistence—the mandatory requirement—that, to be registered, an applicant has to be a member of one of the accountancy professional bodies or has to have tertiary accounting qualifications. So it focuses on accountancy, a point which we will develop. The other requirement relates to the position found not so much in the Corporations Act but in ASIC's Policy Statement 40, which deals with registration of liquidators. It specifies a practical experience criterion but it is a practical experience criterion with, again, an accounting focus. To summarise it, it is five years of public practice—that is, public practice in accountancy—and three years continuously working under the direction of an official liquidator. So we wish to address those two.

These two particulars, which I have isolated and identified, prevent anyone who is not a full-time working accountant in practical terms from becoming registered as a liquidator. In competition law terms, this is a high barrier to entry for anyone else—anyone who is not so qualified—to becoming an official liquidator. In our submission, we say it is an unnecessary barrier to entry; it is an unnecessary barrier to competition. We will develop this, I hope, later in our answers. It is a barrier that results unnecessarily in high costs to those who want to use the services of liquidators and results in a reduced efficiency as well.

The adverse cost and efficiency consequences were the subject of comment—indeed, adverse comment—by the 1997 working party on the review of the regulation of corporate solvency practitioners. When you take into account what a liquidator does, this barrier is neither necessary nor justified. In our written submission at page 7, we say:

The key requirement is the ability to understand the needs and entitlements of a company's creditors, employees, shareholders and other parties and how to achieve the realisation of the assets of a company's operations to best match those entitlements.

But I turn to what a liquidator does and will be focusing on the skills that are needed. Our submission is that you will come to a conclusion that it is just not necessary for a liquidator to be an accountant. Indeed, that was the very conclusion that was reached by the Harmer report in 1988. Of course, that report was done by the Australian Law Reform Commission and by the 1997 working party as well.

As the committee will well know, a registered or official liquidator undertakes tasks of voluntary administration, of receiverships and, in the case of official liquidators, of court-appointed liquidations. As the committee will well know, too, and speaking broadly the role of a liquidator is to take over a business to assess whether it or part of it can continue to operate or not, to sell assets, to recover debts and to see to it that creditors are paid. If I may, at this point, I would like to give to the committee a one-page document. We have attempted to list in schedule form the kinds of tasks that a liquidator undertakes. We have put them into columns—those that are specifically legal skills, those that are specifically accounting skills and those that are combined legal and accounting skills. I hope there are enough copies for the committee.

CHAIRMAN—Do you wish the committee to receive this as an additional submission?

Mr Gotterson—Yes.

CHAIRMAN—As the committee is in agreement, it is so adopted.

Mr Gotterson—Thank you. Members of the committee may note that on the left-hand side of the table, under the heading 'Role of a liquidator', quite a number of tasks—about 15—are listed. We have identified by way of a tick those that, from our perspective, are specifically legal skills, those that are specifically accounting skills and those that are combined legal and accounting skills. To start at the beginning, for example, we would characterise 'Assessing financial viability and profitability of a business' as specifically an accounting skill. Further down the list, 'Assessing creditors' claims, including claims concerning retention of title' we see as specifically a legal skill, as is 'Assessing whether there should be court examinations of directors' and 'Dealing with secured creditors' and so on. There are others which are a combination, as we have indicated. The first of those is 'Liaising with directors and management to finalise and update the company's financial records'.

Senator BRANDIS—Mr Gotterson, I am not sure you can describe 'Selling assets in whole or in part' as a specifically legal skill. You do, but I doubt that characterisation.

Mr Gotterson—We do with that part of it pertaining to documentation and rights in the event of the sale of land. You may, of course, well and justifiably say that the exercise of the negotiation of a price is not necessarily a specifically legal skill—we would concede that. But we would say that at least the settling of contractual documents, as often will be the case with complex drafting of clauses to suit the occasion and so on, would be a specifically legal skill.

Senator BRANDIS—I do not disagree with that, but it seems to me that most of the practical, day-to-day work of a winding-up would be characterised as neither specifically legal, specifically accounting nor indeed a mixture of both but as generically managerial. I notice in that regard that the second category that you have identified, 'Day-to-day management on an interim basis', you do not subject to this mode of classification. A lot of it is work that insolvency managers do, isn't it?

Mr Gotterson—Yes, for those particular matters with an asterisk comment the function is not specifically legal or accounting but is generally carried out by existing management or outsourced. That is to say, even if an accountant is the liquidator, he is not doing it—he is relying on management to do it or outsourcing it. Likewise, if you have a lawyer as the overall liquidator, just as likely that task would be done in-house by existing management or outsourced to an insolvency manager, as you said, Senator Brandis. But one does not see in any of that a justification for withholding to the accountancy profession the role of liquidation—that does not follow at all. We concede, too, in our comments, that you can debate some of the characterisations here.

That kind of exercise justifies what in 1992 led the Trade Practices Commission to say graphically—

and, in our submission, accurately —that

...the role of an insolvency practitioner in Australia today is only indirectly linked to the accountancy profession.

That was in 1992 and it really does remain true today.

In their 1992 paper the commission then concluded by saying that "The fact that some accounting skills (although often not necessarily of a high order) will be essential in any administration, does not necessarily justify confining registration to a narrow group of professionals."

Indeed, that reflects the conclusion that was reached in the Harmer report in 1998 and by the 1997 working party. So we say that accounting and legal skills need to be brought to bear in conducting a liquidation. That is certainly so, but those tertiary qualifications in both accountancy and law—particularly accountancy—are not necessary; they are not sine qua nons. It is currently possible for accountants to hire legal or managerial expertise, which is entirely appropriate. The Law Council does not see why a lawyer should not be able to hire accounting or managerial expertise as necessary.

In the end it is the market which will decide which type of liquidator is appropriate to which type of liquidation. In liquidations that are more concerned with unravelling complex legal issues, then the lawyer-liquidator might well be the more obvious choice. There are a number of us in the room here who all know that liquidations can involve contests. Very often they involve contests over rankings of securities, securities themselves, preferential payments and priority payments. They are legal disputes, and they are often complex disputes. The Law Council believes that the real issue regarding entry requirements for registered liquidators is the applicant's professional standards, expertise and competencies—or to put it another way: can the applicant do the job? We have made four recommendations in our written submission so far as requirements for registered liquidators are concerned:

1. That the legislative and ASIC policy requirements for registration of corporate insolvency practitioners as liquidators be amended to broaden the categories of persons able to act as liquidators.

2. That the eligibility for registration as a liquidator be based on an assessment of an applicant's suitability to undertake the role as liquidator. The assessment should consider matters such as:

–Tertiary qualifications;

–Experience in work likely to enable the applicant to carry out successfully the functions as a liquidator;

–Membership of professional bodies; and

–'Fit and proper person' requirements.

3. That if ASIC is to continue to act as the principal regulatory authority for liquidators, then an advisory body to ASIC be established in relation to ASIC's functions on the appointment, registration and removal of liquidators and the maintenance of professional standards.

We say that membership of the advisory body should be drawn from the professional bodies set out in our submission. They include the Law Council of Australia as well as accountancy and liquidator professional bodies. Lastly, we say:

4. That if the requirement for registration is to include professional membership, then the Law Council of Australia and its Constituent Bodies be recognised for these purposes.

These recommendations together are sufficiently general to allow the development of specific proposals within that broad approach. We envisage that lawyers who are experienced in insolvency or commercial practice will be the ones who would qualify as liquidators. This is not a pitch for all lawyers, just because they are lawyers, to be eligible to be liquidators. We acknowledge that there is a need for specific rules about levels of previous experience and the undertaking of specific courses of study in liquidation. Consideration has to be given to those, and we acknowledge they would be part and parcel of any reform. We are concerned that the criteria, when ultimately settled, are not so overly prescriptive as to effectively amount to a barrier to lawyers entering the market.

There would, in our submission, be benefits to the public that would come from a broadening of the pool of providers of liquidation services. There would obviously be an increase in the number of suppliers, there would be an increase in competition and there would be an increase in efficiency. We are sure there would be, so far as the consumers are concerned, a reduction in fees and costs of liquidation. That is a point we can, later on in answers to questions, develop by reference to comparative scales of fees lawyers charge and those currently allowed for liquidators. There would be an increase in quality, a better range of services and a better ability to pick the type of liquidator who suits the liquidation at hand.

There are some other benefits, too—not just in the competition and cost issue field—that would come about. There would be a capacity to appoint lawyers with an accountant as joint liquidators. The committee may well know that joint liquidators are now commonly appointed. It helps with administration within firms when there are absences. With our proposal, it would be

possible to have a lawyer and an accountant with a mix of expertises input into the one insolvency liquidation. Having lawyers appointed as liquidators in those administrations which principally involve legal issues and legal claims would save time and cost in administration where there are complex legal and accounting issues. In summary on this point, the Law Council's proposals build upon those of the Harmer report and the working group report and it is significant that what we are putting forward has parallels in a number of overseas jurisdictions. They do not mirror exactly, but reflect trends in, the United Kingdom and the United States.

I should move on and say something briefly about the other proposals in our paper. To deal with each of them would take far too long, but I have selected four. I will speak briefly about them and indicate that Mr Jon Clarke, whose speciality is liquidations, can expand upon any of the other recommendations—or, indeed, on the ones I mention. The first of the four I wish to mention is our proposal that directors of holding companies should be liable for the insolvent trading of a subsidiary company. Under the current law, under section 588V of the legislation, a holding company is liable for the insolvent trading of its subsidiary, but it is the holding company only that is liable. For example, HIH was insolvent and that illustrates the problem. What use is a provision making the holding company liable for insolvent trading of subsidiaries if it is also insolvent?

Senator BRANDIS—Would you anticipate that precisely the same principle would apply to the directors of the holding company in relation to the subsidiary as would apply to directors of an insolvent company so that, in a practical though not a legal sense, one would treat the subsidiaries of the same company?

Mr Gotterson—In this particular discourse it would be assimilating the directors of the holding company to the position of directors of the subsidiary.

Senator BRANDIS—I was just wondering whether you thought that, in relation to liability for the insolvent trading of a subsidiary, there should be any additional requirement before the directors and officers—I assume you mean officers as well—of the holding company would be liable?

Mr Gotterson—I will put it this way: to the extent that the law requires certain conditions to be met for a director of a subsidiary company to be liable for insolvent trading of the subsidiary, those kinds of conditions should be reflected in the liability of the directors of the holding company.

Senator BRANDIS—I am just wondering about issues of control. There may be some circumstances in which the operation of the subsidiary is at a remove from the holding company so that you could, I suppose, make a case to say that the directors of the holding company should have broader grounds of excusal from liability than if the insolvent company were the company of which they themselves were directors.

Senator MURRAY—To an extent, the Harmer law reform commission tried to deal with this issue in terms of related companies. It itemised limited circumstances in which the liability transferred between the related company and—what would you call it?—the head company.

Mr Gotterson—Yes.

Senator MURRAY—So to an extent, if I understand your question correctly, those are similar problems, where you have some distance between the activities of the two but there needs to be some connection in terms of liability and behaviour.

Mr Gotterson—Yes, and matters of knowledge. I think Mr Clarke might be able to expand on that.

Mr Clarke—I think the defences to an insolvent trading claim would come into play only if the director of the parent company had the checks and balances in place and the proper reporting procedures in place, and reasonably relied on others—then it would be a lot easier to prove that defence for the insolvent trading of a subsidiary.

Senator BRANDIS—So in other words, you think the defences in their existing form are sufficiently adaptable to apply without amendment?

Mr Clarke—Yes.

Mr Gotterson—I suppose what we have in mind, too, is that under current arrangements it is possible to take advantage of the situation and deliberately ensure that the directors on the board of the subsidiary company differ from those of the holding company and, in a creative way, put up barriers to liability. That also should be addressed as part of it.

Senator MURRAY—What you are referring to, then, is a contrived arrangement—

Mr Gotterson—Yes.

Senator MURRAY—where the legal construction is a shield or a veil over the real substance of the relationship—

Mr Gotterson—Yes, it is.

Senator MURRAY—and the question is, in law and in practice, whether that particular impediment to the proper recovery of insolvencies has ever been dealt with. I think there is a strong feeling that it has not, with respect to related companies in particular—or in respect of certain subsidiary companies—because neither the government at the time nor the government of today have dealt with it.

Mr Gotterson—We would say that is an example, or the worst case, but we would not seek to confine liability of holding company directors only to the circumstance where it can be proved there has been a device or a deliberate use of a device. It would have to be more extensive than that circumstance but, of course, subject to the defences that you were alluding to before or modification of them for holding company directors.

That was the first of the points. The second one is a need to bring into alignment what is recoverable where there are insolvent trading aspects under sections 588M and 1317E. To make the point, section 588M concerns proceedings instituted by liquidators and they are proceedings for compensation where there has been insolvent trading. But the course of decisions in the courts now has limited what is recoverable under that section to the total of debts that have been

incurred during insolvent trading. That was established in the recent case of Waterwheel in the Victorian Supreme Court. Contrast that with section 1317E. That is a civil penalty proceeding rather than a liquidator's civil proceeding. Under that section, all losses—not just trading losses; capital losses as well—are recoverable. There is a bifurcation or a departure there which seems illogical. There is a need to align or to bring them together so that the scope of recoverability of items recoverable under each coincides.

The third matter deals with administrators and what they should be required to provide to the first meeting of creditors. There seems to us insufficient time in the mere five days allowed before the first meeting to assemble sufficient useful information for creditors. We think a longer time—perhaps 10 or 14 days—should be allowed and better detail be given concerning the administrator's relationship, if any, with the company and with the directors, and more and better detail about their projected fees and charges.

The last point, if I can mention it, is that there should be a statutory prohibition in the nature of a moratorium against third parties who intervene and bring a potential administration to its knees by taking advantage of contractual provisions. We have in mind here the standard provision that one finds where if there is an administrator appointed then a contract can be terminated. There are also provisions where, in the context of bank guarantees, if an administrator is appointed a bank guarantee can be clawed down. Often immediately upon appointment those sorts of provisions are invoked and it becomes impossible to proceed usefully with the administration. There is a need for a statutory provision—a true moratorium—which would be likely to enhance the administrator's ability to resurrect the company or to obtain maximum value for its assets.

Senator MURRAY—You specified 10 business days, didn't you?

Mr Gotterson—We said 10 or 14. We did not have—

Mr Clarke—It is meant to be business days.

Senator MURRAY—I was surprised it was so short, frankly. Is it because you are constrained by the 30-day period during which you must produce a first report?

Mr Clarke—We actually also think that with the second meeting the time should be expanded as well because what is actually happening is that more often than not administrators are going to court to get an extension of time for the second meeting. There is a balance between having, say, 10 business days and perhaps expanding that to 20. The whole process is designed to be quick and efficient. We think that by going beyond 10 some administrators are going to become a little bit tardy with their administration.

Senator MURRAY—To pursue that a little: it depends on the circumstances, because in some cases I can see that five business days would be more than enough, and in complex circumstances I think you would be really pushed to do it over 10 business days. Is there any way in which there could be some flexibility according to the complexity?

Mr Clarke—Only by applying to the court for an extension of time in relation to the first meeting, which is presently not available.

Senator MURRAY—Would you suggest that, if the law was changed, there would be scope for making an application for an extension of time?

Mr Clarke—That is not part of our submission, but yes.

Senator MURRAY—I think that is an important consideration. I can see circumstances where 10 business days would be far too short a time period. Sorry, Mr Gotterson.

Mr Gotterson—I was just about to conclude by urging the committee to take the opportunity to recommend measures that will enhance the operation of the insolvency laws, particularly the measures that we recommend. We see them as proposals that make sense in terms of what a liquidator does. They reflect the recommendations in several considered reports and they will benefit the public. Insolvency—it has to be said—is an area that is marked with studies, reports and recommendations, most of which, regrettably, slip through the cracks. It is probably because of the many other reform pressures in corporate law that crowd into the agenda. We think lawyers as liquidators is a good example of that or, from our perspective, perhaps a bad example of that. This is an opportunity for the committee to correct it. On that note I would invite any questions that you may have for us.

CHAIRMAN—Thank you very much, Mr Gotterson. In relation to your proposal to broaden the criteria and the range of people who could be appointed as administrators or liquidators, how do comparable jurisdictions in the United Kingdom, New Zealand and the like set their entry requirements for insolvency practice? Is it is similar to what you are proposing or is there another way?

Mr Gotterson—I will preface the answer by saying that usefully, in the 1992 Trade Practices Commission report, there was a summary of that. We will be in a position to perhaps provide photocopies of it for the committee later. Mr Goode has been researching that very topic, and I ask him to supplement the answer.

Mr Goode—According to the Trade Practices Commission report back in 1992, in New Zealand at that time there was no registration or licensing for insolvency practitioners. I am not able to say how many lawyers there are involved in it there. In the United Kingdom, back at the time of this report, I believe it said there were 2,000 insolvency practitioners. Around 200 were from the legal profession, but they had some fairly hard criteria to overcome. The executive director of the Law Society of South Australia earlier this year sent off a list of questions to a number of societies, including societies in the UK, and I think the number of practitioners was down to 160 or 162 lawyers now out of about 3,000 insolvency practitioners. I can double-check those figures but in Scotland we were told there were very few lawyers there, and the comment made in response there was that it was because of the very difficult criteria.

I note, again, the Trade Practices Commission report talked about the issue of whether or not a liquidator needed specific accounting skills. The comment was made at page 71 of that report that a lot of functions were in fact contracted out to other service providers by insolvency practitioners at the moment. The comment was also made that the liquidator fulfils the role of central administrator overseeing the various tasks. There was a footnote to that report at page 71, which said:

It is of interest to note that in the US, where there is more of an emphasis on the use of lawyers as the central administrator, it is accountants who are often given the contracts to perform necessary accounting tasks.

In the United States, for example, there is more emphasis on the lawyers rather than the accountants. I can say that, many years ago, a liquidator came from Denmark to instruct us on a matter in South Australia and, much to my surprise, he was a lawyer. In Denmark, for example, lawyers are often liquidators. I do not have precise details of their level of qualifications.

Mr Gotterson—To give a bit more detail on the position in the United Kingdom, we got some information in November last year, which was provided by the Law Society of England and Wales. The criteria for an applicant there is that they have to pass the joint insolvency examination, they would normally have been admitted as a solicitor for at least three years, they hold a current unconditional practising certificate and will have had significant involvement in technical insolvency work during the three years preceding the date of the application—that usually means between 600 and 1,000 hours of technical insolvency work. The fallout is that there are 162 solicitors authorised by the Law Society to be insolvency practitioners of an estimated 3,000 insolvency practitioners in the UK. That does not include the figures for Scotland where there are additional insolvency practitioner solicitors.

Mr Goode—The email response from the Law Society of Scotland states:

However there are only 19 Scottish solicitors who hold such licences.

They obtained special qualifications with, as the email states:

... a 3 part specialist insolvency exam run by a UK-wide insolvency trading body. The exam was very hard hence the low number of solicitors with the licence. Also the solicitors have to have 3 years relevant insolvency experience.

That is one of the problems that we have here: the fact that we have to work for a liquidator effectively before we can get the licence. That is the barrier that we face.

CHAIRMAN—One of the issues raised in submissions to the inquiry is the level of fees and the cost of administrations. Given the general public's perception about lawyers' fees, how would you see a greater involvement of lawyers in insolvency cases, administrations and liquidations being beneficial in that regard?

Mr Gotterson—Liquidators have been lucky because, relatively, they are few on the ground so their fees have not attracted public opprobrium and a description of that type. I think Mr Clarke is able to provide some more insight.

CHAIRMAN—I think that they have. As I said, from the submissions that we have received, there is concern about the fees that are charged by liquidators.

Mr Gotterson—Yes.

CHAIRMAN—Given that there is also general concern about lawyers' fees, how will bringing more lawyers into the operation as liquidators serve to be beneficial in reducing the costs of administration?

Mr Clarke—Generally speaking, Australia-wide, and in some jurisdictions the difference is significant, lawyers' hourly rates are lower. Also, there is a lot of duplication with the accountants. Coming to Senator Brandis's example of selling a business, lawyers are involved with clients selling businesses all the time. The accountants have to do the assessment, give the instruction to the lawyer, so there is a lot of double handling that proceeds.

CHAIRMAN—Do you think that, as was suggested by the Australian Workers Union in their submission, there should be either an independent body or a government department that monitors the fees charged by administrators?

Mr Clarke—That suggestion has been around for 15 or 20 years and it has always been rejected because it is such a difficult thing to monitor, and it is really driven by market forces. What is happening at the moment is that it is exclusively for the accountants and they are really setting their own rates, which, state by state, no matter whether the practitioner is from a large firm or a small firm, tend to be about the same level.

CHAIRMAN—Another concern that has been raised is the issue of the perceived absence of impartiality on the part of administrators, particularly in relation to voluntary administration. This was raised by the Taxation Office and others in submissions to us. The Taxation Office suggested a roster system as a means of selecting administrators and liquidators. Do you see that as a practical solution to the issue of impartiality?

Mr Clarke—It would not work. For example, you might need an insolvency practitioner specialised in the wine industry but on a roster system you might get somebody appointed as the insolvency administrator who does not know anything about that particular industry.

CHAIRMAN—On page 15 of your submission, at paragraph 6.2, you say:

> An additional matter the Committee raises is in respect to directors' duties pursuant to part 5.8A of the Act. Section 596AB provides that a person must not enter into an agreement or transaction with the intention of or with the intention that includes the intention of preventing the recovery of the entitlements of employees of a company or of significantly reducing the amount of those entitlements.

One of the concerns that have been raised with us is the issue of deeds of company arrangement being drawn so that they militate against employee entitlements being obtained and, in some cases, tax liabilities being met. We had evidence in Melbourne last week from a couple of employees which highlighted this fact, where the deed of company arrangement prevented the government standing in the shoes of the creditors and therefore these employers were not even able to get their entitlements through GEERS. Do you have any comment on deeds of company arrangement being used in that way?

Mr Clarke—That surprises me. It has generally been acknowledged that with a deed of company arrangement the priority provisions, in particular with relation to employee entitlements, should be preserved—and if they are not preserved then it is the kind of deed that the court would strike down and then wind up the company. With respect to GEERS, one of the concerns of our committee is the uncertainty of where GEERS rates with respect to subrogation: if there are payments made to employees under the scheme then does the Commonwealth have

rights of subrogation under a deed of company arrangement? At the moment, the law is silent on that—and that probably should be addressed.

CHAIRMAN—You are also concerned about that reference in 596AB referring to a person. You believe it should also refer to directors of a corporation as well, do you?

Mr Clarke—I think that that is an oversight. If an action is taken against a company under 596AB for conspiring to do something so that employees are not paid then it is only the company—and it might be a $2 company—that is going to be liable. We are saying that the law should go further and make the directors of that company accountable as well.

CHAIRMAN—Do you think unsecured creditors generally have sufficient control over what can be written into a deed of company arrangement?

Mr Clarke—Singularly, no; as a group, they certainly do because it is 50 per cent in number and value that actually attend the meeting either in person or by proxy.

CHAIRMAN—Your proposal that ASIC have a role in determining whether a deed of company arrangement should be set aside. Is that conferring some sort of judicial power on ASIC that is not appropriate?

Mr Clarke—No. The intention is to give ASIC the power to give a show cause notice as to why it should not be set aside. ASIC quite often, in other areas, give show cause notices as to why certain things should not happen, so it is putting the onus back on the promoters—who are normally the directors of the scheme—to show cause why it should not be terminated. If they do not show cause or do not get relief from the court then the deed should automatically be terminated and the company wound up. At the moment it is up to the creditors to go to the court, and spend the money to do it, to have a deed set aside.

Senator MURRAY—To put it more colloquially, I am sympathetic to your desire to 'bust open the closed shop'. But the question follows from that: why should it stop at the legal profession? I think that that was implicit—or explicit—in some of the remarks made earlier. People with serious and credible business experience, for instance, may be suitable insolvency practitioners in certain circumstances, and the skills you refer to can always be, as you put it, outsourced or hired. It struck me that your matrix was a much better activities matrix than a skills matrix. I have known non-lawyers who are very good at the jobs you have indicated—the specialist lawyer skills—and you probably have as well.

Mr Gotterson—I think that our complaint has been with the barrier, and the solution that we have offered is one that would accommodate us but is not intended to accommodate us only. We would agree, Senator Murray, with what you have just said.

Senator MURRAY—If you move from there and say anybody who is capable should be able to do the job—which is a kind of free market philosophy, if you like—the next question would be: you do need some criteria to do the job; how would you establish them? If I understood Mr Goode's remarks correctly, the threshold has been raised so high and so restrictively in some other jurisdictions that having it open to anyone almost proves irrelevant because only certain kinds of people can access it. So the question we would want to ask is: if we accepted your

proposition—and you, obviously, know from my remarks that I am sympathetic—how or by what means would we as a committee recommend the criteria, certification, licensing or whatever system you propose be devised in a less regulated but still prudential manner?

Mr Goode—Perhaps we would expand on that in a supplementary submission. I just turn to your point about people other than lawyers. We got a response from the Hawaii State Bar Association. Over there, apparently, they maintain a schedule of professionals to act in certain capacities—as receivers, for example. But they:

> … will entertain proposals from parties in interest where the management of unique assets or enterprises, calling for unique management experience, is at issue. (For example, if management of a hotel is at issue, it may be more productive to have a receiver with experience in the resort industry, while in cases requiring management of an entity whose assets are claims in litigation, an attorney might be more suited to the responsibility.)

So it appears—certainly in Hawaii and probably in some other US states—that they do not have it limited just to lawyers or accountants but also recognise other people with experience in a particular area.

Senator MURRAY—The next part of my question is, to me, then critical. If you have an open market as to who can do the job—provided they are competent—what is the process by which those new competencies should be established?

Mr Clarke—On page 8 of our submission we refer to the Law Council recommending the establishment of a formal mechanism through which a number of professional organisations would play a direct advisory role to ASIC to set the standards for admission and supervision, and also for taking away the licence of a liquidator.

Senator MURRAY—Yes; I saw that, Mr Clarke. But my fear was that, if it is the same bodies who want to hold the closed shop—or, perhaps, enlarge the closed shop a little more—we have the same problem. So, if you want to open up to competency alone and not just to professional certification as a lawyer or accountant, you would need to make sure that the people devising it were not just lawyers or accountants. That is really my point. Perhaps, rather than pursue it at length—and I hesitate to do it if the Law Council was not able to—if you felt you could think a little more on that and, perhaps, come back to us with a view of it, I would be grateful.

Mr Gotterson—Thank you.

Senator MURRAY—The other area of concern I had was raised earlier by Senator Brandis; it is that problem with related companies raised by Harmer. It is the problem, in a sense, which is in the phoenix company area—that is, how you get through legal constructs of different kinds of entities in different time frames where the ability to get at people in insolvency circumstances and make them cough up what is necessary is very difficult. I wondered if you had given more thought to the Harmer law reform commission on related companies—their recommendations have never been carried through—and whether you had given much thought to the Cole royal commission remarks on the phoenix company phenomenon and how that was to be dealt with.

Mr Clarke—Certainly, in relation to phoenix companies we have. At the moment the only prohibition is against a director who has been disbanded. We see that that should be expanded to

include related entities of a disbanded director. Whether it is a spouse or some other relative being appointed as a director of the phoenix company, there should be a provision that that is illegal.

Senator MURRAY—The one other issue—before I close off—is whether you have given much though to the issue of independence. Increasingly, this committee and other committees who are interested in areas of corporate behaviour have had to focus on the issue of whether genuine independence exists—for instance, valuers are an issue with auditors and so on. In the resolution of insolvency matters where valuations are particularly important, where the way in which assets are realised is important, where consideration of contractual situations is important, particularly where you have got areas where the expertise in that field of industry is very narrow—like very scientific or very complex companies—I wondered if independence had been an issue that you had some doubts or concerns about, in terms of proper definitions and determinations in existing insolvency law.

Mr Gotterson—I do not think it is a matter that our committee, of the Business Law Section, has looked at. May we look at it and incorporate that in a submission?

Senator MURRAY—To summarise my question: the issue of independence is now a core issue in operating companies—ensuring independence is there in the manner in which accounts and accountability are pursued. The flip side must be there in the insolvency area as well, I would have thought—you outsource for an auditor or a valuer and so on. Are there sufficient checks to make sure that there is sufficient independence? It is a much bigger issue in Corporations Law generally now, and I wondered if it was, or if it should be, also attended to in insolvency law?

Mr Gotterson—Is this in the context, perhaps, of independence from the liquidator?

Senator MURRAY—I am no expert; I would not draw any conclusions about the way in which liquidators are behaving. But liquidators frequently use services to provide them with the resources and understanding that they need. In such circumstances, as I recall, they are required to ensure people are appropriately independent.

Mr Gotterson—Concerns about cosy arrangements—yes, I understand.

Senator MURRAY—That is right. I am just asking you a general question. Because we are becoming so concerned about it in operating companies, should we have a similar concern in situations where insolvency has to be dealt with?

Mr Gotterson—May we look at that?

Senator MURRAY—Yes.

Mr Gotterson—I would be grateful.

CHAIRMAN—If there are no further questions, can I thank each of you for your appearance before the committee and for your contribution to our inquiry. Thank you very much.

Mr Gotterson—Thank you, Mr Chairman, and also members of the committee.

[5.42 p.m.]

BERGMAN, Mr David, Adviser, Policy and Legislation, Insolvency and Trustee Service Australia

GALLAGHER, Mr Terry, Inspector-General in Bankruptcy, Insolvency and Trustee Service Australia

CHAIRMAN—I welcome representatives of the Insolvency and Trustee Service Australia. The committee prefers that all evidence be given in public but if at any stage of your evidence or answers to questions you wish to give evidence in private you may request that of the committee and we will consider such a request to move to in camera. I invite you to make a brief opening statement—or an opening statement of whatever length you choose—at the conclusion of which we will have some questions.

Mr Gallagher—Thank you. I would like to make a brief opening statement. I would like to start by giving you a brief overview of the current arrangements for administering personal insolvency in Australia. A number of points of difference between personal and corporate insolvency are noted. They flow essentially from obvious differences between corporate and natural persons, but there is no endeavour to comment on the different legislative and administrative arrangements currently in Australia. They are policy matters. The personal insolvency system is essentially administered and regulated by the Insolvency and Trustee Service Australia—an executive agency within the Attorney-General's portfolio.

As you are aware, administrative and policy responsibility for personal and corporate insolvency is separated in Australia. ITSA, acting as either the Inspector-General in Bankruptcy, an official receiver or the official trustee, performs a range of functions in the system, providing a registry service, acting as a trustee in bankruptcy, regulating practitioners, exercising coercive and enforcement powers, investigating fraud under the Bankruptcy Act, undertaking administrative review of trustee decisions and giving advice on policy and legislation to government. ITSA's registry functions include accepting debtor's petitions, processing debt agreement proposals, maintaining the national personal insolvency index, issuing bankruptcy notices, keeping records, and providing information to the public and to people involved in bankruptcies about how the system works.

The courts have a very limited role in the system, as many of the functions once performed by the courts are now performed administratively by official receivers. The official receivers also provide investigative assistance to trustees by exercising search and information-gathering powers on their behalf. The official trustee is appointed in those cases where private registered trustees are not appointed and, indeed, is the trustee in over 90 per cent of administrations. This means that all personal bankruptcies are investigated and administered and creditors can be confident that, where there are assets available, they are likely to receive some payment.

ITSA has taken a proactive approach to the Inspector-General's role in regulating trustees, including the official trustee. All of the 150 or so active trustees are inspected at least annually to ensure compliance with the legislation and their duties as trustees. Last year some 750

administrations were inspected and over 150 part X meetings attended. Insolvency practitioners recognise the importance of this in maintaining the integrity of their profession and generally respond favourably to this regulatory approach. In addition, the Inspector-General has an administrative review role in relation to many decisions made by trustees. This has improved the efficiency of the system.

ITSA has also become much more active recently in investigating and referring offences under the Bankruptcy Act. Last year almost 600 matters were referred, 300 investigations were completed and 48 people were convicted of offences. This is an important part of ITSA's role in ensuring public confidence in the bankruptcy system.

Australia's insolvency systems are designed to ensure that individuals and companies in difficult financial circumstances are able to get relief from overwhelming debts and that creditors receive what is available from the debtor's property. This need to obtain relief from debt is arguably more pronounced when dealing with individuals than it is in dealing with corporations. Individuals continue to be liable for their debts until they have been paid or until the debt is discharged, and the individual needs to be able to continue living his or her life even after bankruptcy. This is different to a company liquidation, which results in the company being wound up and the directors and members of the company generally bearing no direct personal responsibility for the company's debts.

In personal insolvency, it is vital to find an appropriate balance between the rights of creditors to be paid from whatever property is available and the rights of the debtor to obtain relief, be rehabilitated and move forward. As a result, there are several features of the bankruptcy system which are unique to personal insolvencies. These include a bankruptcy period during which the bankrupt's financial activities are restricted, opportunities for repaying creditors extending beyond the property available at the time of bankruptcy so that after-acquired property also vests in the trustee and the bankrupt can be required to make contributions from his or her post-bankruptcy income and, finally, there is the concept of discharge whereby the bankrupt is discharged from all provable debts at the end of the bankruptcy period.

There have also been a number of changes in recent years in response to changes to the types of people becoming bankrupt. The significant rise in the number and proportion of consumer bankruptcies, so-called, in the past 10 years means that the majority of bankruptcies are no longer the result of business failure. There has also been a noticeable rise in the number of small businesses which incorporate, which means that many small business failures are no longer dealt with through the personal insolvency system. These changes have meant that the personal insolvency system has had to adapt to a user base significantly different from that which existed when it was first designed. The introduction of debt agreements in 1996—a product tailored specifically to individual insolvency—is perhaps the most significant outcome of these changes.

Another significant change, although from an administrative rather than a policy and legislative perspective, has been the streamlining of the procedures within ITSA for handling assetless bankruptcies. I could elaborate on that further if the committee wishes.

The policy response to these changes in the nature of bankruptcy has involved social justice as well as commercial considerations. It has resulted in some features which are unique to personal insolvency, including: a discretion to reject a debtor's petition where it would amount to an

abuse of the bankruptcy system; exemptions for divisible property such as superannuation, tools of trade, household property, sentimental property and a motor vehicle up to certain dollar limits; and, finally, exemptions to provable debts so that a bankrupt does not avoid responsibility for debts arising, for example, under court fines and maintenance orders or agreements including child support.

A key difference between personal and corporate insolvency is that, when an individual becomes bankrupt, the person hands over all of their affairs up to the date of bankruptcy to a trustee. But the bankrupt needs to be able to continue earning a living, spending money, dealing with creditors and generally living their lives. Upon becoming bankrupt, the person's property vests in the trustee. The trustee is bound by the general law obligations of a trustee, as well as the specific obligations imposed by the Bankruptcy Act. The duties owed by the trustee to the bankrupt are just as significant as those owed to creditors. The trustee is obliged to realise the bankrupt's property for the benefit of creditors and also has some limited ability to control the ongoing affairs of the bankrupt. For example, there are restrictions on the bankrupt's ability to travel overseas without the trustee's permission after acquired property forms part of the available property for distribution to creditors and the trustee can collect income contributions from the bankrupt's post income. The bankrupt is obliged to keep the trustee informed about changes in his or her circumstances during the bankruptcy period and must disclose his or her bankruptcy to potential creditors when applying for credit. So there are a number of factors different to the situation in corporate insolvency.

The trustee may be a private practitioner or, where no private trustee is appointed, the official trustee becomes the trustee. An important feature of Australia's bankruptcy system is that a trustee is always appointed. The official trustee effectively acts as the default trustee. This means that all personal insolvencies are administered, including an appropriate level of investigation which enhances creditor and community confidence in the system.

In conclusion, the current system, which I have sought to describe, is generally considered to work efficiently and effectively. ITSA employs some 250 people, with an ongoing budget of approximately $27 million, and recovers approximately $18 million in fees and charges. The roles that ITSA plays differ in many respects from those of ASIC in relation to corporate insolvency and are of a kind which I believe suit the personal insolvency regime.

CHAIRMAN—Do you have anything to add, Mr Bergman?

Mr Bergman—No.

CHAIRMAN—We would like to raise with you the issue of the potential for merging corporate and personal bankruptcy insolvency law and administration. In the United States and the United Kingdom, the two systems have been successfully merged, as I understand it. The 1997 Review of the Regulation of Corporate Insolvency Practitioners recommended that the government examine the costs and benefits of a merged regulatory framework for personal and corporate insolvency, with separate licences for each area of practice. Has ITSA made any assessment in relation to areas of regulatory activity undertaken by ITSA and ASIC, as to whether there might be administrative savings under a merged system?

Mr Gallagher—We have made no costings along those lines. We are obviously aware of the working party report and that a merged system has been an issue for some time. But, essentially, it is an issue for government to decide. I have sought to set out how the system works in relation to personal insolvency, but there has been no examination by us of any costings, savings or benefits that might arise from a merged regime.

CHAIRMAN—Some of the submissions that we have received and also some of the professional literature that we have noted indicate an increasing divergence in law and policy between personal and corporate insolvency. Does ITSA have a belief that there is a need to maintain elements of consistency between personal and corporate insolvency policy when you make recommendations to government or is your policy development process independent of developments in the area of corporate insolvency?

Mr Gallagher—I will answer that in a general sense, and I will invite David to comment if he so wishes. We are very mindful of a need to maintain consistency between the two systems and the legislation relating to the two systems whenever developing policy. We certainly maintain a dialogue with Treasury and ASIC as well in relation to policies and practices.

We also liaise consistently with the profession and receive their feedback in relation to areas where there might be differences. So we do endeavour to maintain consistency where we can. Where, for example, legislative reforms are proposed in the corporate area, we would be consulted and we would advise whether they suggest an appropriate adjustment to bankruptcy law, and vice versa. Some of the changes that have been made by government, though, have been made specific to corporate insolvency—for example, employee entitlements. Decisions have been restricted to companies of a certain level or where certain amounts are involved, so they have been made specifically different.

CHAIRMAN—Are you able to comment on the achievements and cost savings arising from the memorandum of understanding between ITSA and ASIC, in relation to overlap in your responsibilities with respect to suspected offences under the Bankruptcy Act and the Corporations Act—where a director might have been bankrupt, for instance?

Mr Gallagher—I do not have any costings on that. Again, it is a matter of maintaining a dialogue with them so that areas of potential duplication are avoided. I do not have that information now, but there are cases where individuals who are under investigation may also be under investigation in the other area, and we would seek to avoid duplication in those cases.

CHAIRMAN—Section 305 of the Bankruptcy Act enables the Commonwealth government to underwrite the costs of inquiries in relation to the estates of bankrupts or deceased debtors, of instituting proceedings and so on. Can you tell me how the funding for that is provided? Is there a specific annual allocation in the budget? Can you tell me how much was expended on that last year, as an example?

Mr Gallagher—I have some information on expenditure. Generally, though, the funding comes from within ITSA's annual budget and the applications for section 305 funding are made, assessed against certain criteria and then funded if those criteria are met.

Mr Bergman—Within the last financial year, for example, there were 39 applications received for that funding, of which 35 were approved, and the total amount of the indemnity approved for those 35 applications was $199,993. That was down significantly from the previous year, in which $646,329 was approved for 50 applications.

Mr Gallagher—The criteria are pitched at endeavouring to fund those cases where there is—it is a loosely used term—a public interest involved. Just because there is no money in an estate and the trustee wants to—or even perhaps should—carry out investigations to pursue an asset, that would not justify funding. That would be a matter for creditors to decide in the vast majority of cases. So it is only in those cases where there is an absolute obligation to defend litigation or where there is some other general public interest associated with the matter, and there is not the opportunity for creditor funding, that section 305 would be used.

CHAIRMAN—Have you found any difficulties in administering the criteria to determine whether 305 should be used?

Mr Gallagher—No, we have not had difficulties. There are certain criteria that are set out and they are made clear to trustees so, when decisions are made, we explain the decision against those criteria. They have not presented a problem.

CHAIRMAN—How does the rate of recovery compare with the amounts advanced under the scheme?

Mr Bergman—During the last completed financial year there were 27 of those funded matters which were completed, for a range of different types of actions. In 25 of those cases the benefit that was sought was obtained—that is a 92 per cent success rate.

CHAIRMAN—Did the benefit exceed the cost of the action?

Mr Gallagher—I do not have those figures in front of me but I would be very surprised if the amount that was ultimately recovered—and of course this money is a first charge on any moneys recovered—exceeded the payments. A number of them are quite small instances where the debtor has refused to provide a statement of affairs or there is some action that has been forced on the trustee that has to be defended. If it gets to any significant litigation, inevitably there are significant assets at stake and it really then turns on the creditors being prepared or not prepared to put the money up.

CHAIRMAN—One of the issues that has been raised in this inquiry is the issue of assetless companies where creditors are generally not willing to fund an administrator unless there is likely to be some return to them from that. There is no equivalent provision in the Corporations Act to the 305 section of the Bankruptcy Act. In the light of your experience with section 305 can you see advantages in a similar provision being put into the Corporations Act for the Commonwealth to fund action?

Mr Gallagher—I would be inclined to think that the 305 funding is not directed to assetless companies or administrations in that case. Rather, it is directed at issues associated with a matter that may raise questions of law or have other public policy implications. That may go to concealed assets, and it is in the public interest for the credibility of the system. But a very

strong test is that if there are assets available to be recovered and the prospect of recovering them is likely then really it is a commercial decision of the creditors. They are not, generally speaking, the circumstances where we would fund a trustee. They go to those other, loosely termed, 'public interest considerations'. I think it would be fair to say that it is more the case now with the advent of litigation insurance as a more readily available vehicle.

Mr GRIFFIN—You mentioned earlier that there has been a rise in small businesses incorporating. Over what sort of time frame are you talking about and to what degree?

Mr Gallagher—It is a general statement that I have made; I do not have the statistics on that. It is an observation that we have made in relation to the kinds of administrations that we see coming across our plate, as it were, in personal insolvency. We do have statistics on the proportion of total bankruptcies that are business related now compared to the case 10 or 15 years ago. The proportion has reduced from some 30 per cent in the middle to late 1980s—and these figures are in my annual report to parliament and can be checked. In that period probably 30 per cent of bankruptcies were business related bankruptcies. Now it is some 15 per cent or 16 per cent.

Mr GRIFFIN—You mentioned debt agreements but you did not actually go into much detail in respect of that. My understanding is that they have been increasing exponentially over the last several years. Could you just talk about those for a while?

Mr Gallagher—Yes. Again, I have not brought the statistics but the numbers have increased very substantially, although from a very low base. They were introduced in 1996 and there was a half year that year and some 50 or 60 were entered into. They did take a little time to gain acceptance amongst creditors and for people to be made aware of them. In the last two years or so they have really grown. Last year close to 5,000 debt agreements were entered into and that represents well over 20 per cent of total administrations.

Mr GRIFFIN—And you see that probably growing over time?

Mr Gallagher—It is difficult to make an assumption about that. If you look at the take-up across Australia, there are differences between states. For example, if you match the take-up in Queensland with that around Australia, you would get an increase. But there also a settling down process occurring with them where creditors are becoming a bit more careful about those ones that they do agree to, to ensure that the debtor can pursue them for the period of the agreement. So I think there will be a settling down period. If you draw on overseas experience, Canada have probably got the closest regime to our debt agreement regime. They have some 15 per cent of their total insolvencies in these voluntary administration schemes. So we are guarded in the predictions we are make: they are increasing but whether they keep increasing at the current rate is problematic.

Mr GRIFFIN—Is there any evidence that you are getting a repeat offender situation where someone is going into a debt agreement, it is not working out and they have had to go into bankruptcy from there? Is it too early in the stats to say?

Mr Gallagher—I would have to provide that information to you. The information is available; I just cannot recall it. A percentage of debt agreements that fall over lead into

bankruptcy. It is, on my recollection, not all that high—not as high as you might expect—but it is a percentage of them. I am hesitant to quote a figure. I have seen a number and the information can be provided. It would be better to do it that way.

Mr GRIFFIN—Do you have a view as to how the increase in debt agreements has been driven? Has it been driven by creditors or otherwise?

Mr Gallagher—I think the evidence is fairly clear that it is driven by the emergence of administrators who have identified this system as an opportunity and have promoted them. That said, in the end the debt agreement cannot be entered into unless the creditors agree to it. So we have spent quite a lot of our time talking to creditors to encourage them to support debt agreements in appropriate circumstances because they are in most cases a legitimate effort by the debtor to try to come to some arrangement. The promised return on debt agreements is some 70c in the dollar. Given the criteria for entering into them—you have to be on a fairly low income—it is much better than what they would get under bankruptcy, so in that sense I think there is a greater creditor acceptance of them. But the numbers do seem to relate to the number of administrators who are available in the various areas to administer them.

Mr GRIFFIN—If debt agreements were not there, do you think all of those people would be going bankrupt or would other things be happening?

Mr Gallagher—I think it is a really hard thing to offer a total conclusion about. For example, in the most recently completed financial year total insolvency numbers fell by one or two per cent, which was a factor of bankruptcies falling by six or seven or eight per cent and debt agreements rising by an almost commensurate number, so those figures on their own would suggest that there is a displacement occurring, that bankruptcies are being displaced by debt agreements. But when they first took off they took off without bankruptcies falling commensurately, and I think there is a bit of a time lag so a person is likely to enter into a debt agreement hopefully before they would end up in the bankruptcy situation. That is a good thing. If we can try to get to these debtors earlier so they have an opportunity to come to some resolution then that is better than letting the situation deteriorate to the point of bankruptcy. The statistics suggest that there is a displacement occurring, which is a design outcome, I think.

CHAIRMAN—Can you give us some information on non-payment of employee entitlements in the context of personal bankruptcies? That has been a considerable issue in relation to the corporate insolvency submissions.

Mr Gallagher—We do not have information on that. We know that there are only a very few cases in personal insolvency where GEERS has been invoked, so whether that can lead to a conclusion—but we just do not have the statistics on non-payment of employee entitlements in bankruptcy situations.

CHAIRMAN—Are you able to give any assessment as to whether the maximum priority proposal, which the government announced in September 2001 and which, in relation to corporate insolvency, placed employee entitlements ahead of all other secured creditors, would have any implications for the administration of bankruptcy law?

Mr Gallagher—My recollection is that the proposal had a threshold in relation to the size of the business, which would have almost cut out any conceivable bank personal insolvency but, other than that, I do not think I would be in a position to make any comment or observation.

CHAIRMAN—Thank you very much for your appearance before the committee this evening.

[6.17 p.m.]

KEAY, Prof. Andrew Richard, (Private capacity)

CHAIRMAN—I welcome Professor Keay to our hearing via phone link-up with the United Kingdom. Do you have any comments to make on the capacity in which you appear?

Prof. Keay—I am Professor of Corporate and Commercial Law in the Department of Law at the University of Leeds in the United Kingdom. I appear in a private capacity.

CHAIRMAN—The committee prefers that all evidence be given in public, but if at any stage of your evidence or answers to questions you wish to give evidence in private you may request that of the committee and we will consider such a request to move in camera. I invite you to make an opening statement, after which I am sure committee members will have some questions.

Prof. Keay—I would like to touch upon several issues that were raised by your May issues paper and make a preliminary statement. As you may know, I have been living here for six years. Apart from trips back to Australia for professional and personal reasons, I do not have the same conversance with the state of play in Australia as when I left. But I do read widely, I keep in touch with academic colleagues and practitioners, and I have written a book in the last couple of years dealing with Australian insolvency law.

As you know, the federal legislature in Australia has been wrestling with insolvency law ever since the handing down of the Harmer report in 1988. This has been a commendable approach by government. It compares well with the United Kingdom, which until last year had done very little in comparison. It is good to see the government considering how the rules relating to insolvency law should change.

There are about four areas I feel I have some expertise and interest in that I would like to cover. The first one is voluntary administration, which has obviously been a focus of your committee. I know you have considered meetings in administrations. In relation to the time set for the first meeting, it is probably trite to say that the meeting schedule period is very tight. Even where you have a small to medium sized company, it is sometimes difficult for the administrator to comply with the necessary procedure. The procedure has been used by larger companies. Originally, I think the Harmer committee anticipated it being used by just small to medium sized companies, but larger companies have availed themselves of this procedure. The problem is obviously the time constraints.

As well, all that happens at the first meeting is that the administrator will have his or her position confirmed and the creditors will decide whether they form a committee of creditors. Unless there is a wrangle over the appointment of the administrator and whether a new administrator should be appointed, the meeting can be very short. From the anecdotal evidence I have heard, administrators can sometimes be rather embarrassed by the shortness of the meeting, which may last only a few minutes. They are rather embarrassed that the creditors turn up for such a short meeting. There is usually no information the administrator can give to the creditors at this early stage, save for very preliminary thoughts. Probably the best the administrator can do

is outline the procedure, which can be very useful for creditors. But one wonders whether this is going to be a very useful meeting, given it is only a few days into the administration.

The creditors cannot usually know at that stage whether the administrator is a tame administrator in the pockets of the directors or is going to do a good and competent job. If the meeting were held further into the administration, it seems to me there would be more opportunity for investigation by the administrator. The administrator would be able to tell the creditors more and the creditors would be better prepared and would know whether the administrator was doing his or her job properly.

The avoidance provisions in part 5.7B of the Corporations Act permit liquidators to attack transactions that were entered into prior to the liquidation. When the Corporations Law was amended in 1992 to introduce administration, it did not give administrators the power to attack those types of transactions—pre-administration transactions, in other words, such as preferences. That might be a weakness in the provisions, because it means that the administrator cannot attack any of those pre-administration transactions. If he or she could, it might be possible to obtain a better deal for the creditors because the directors, in putting a proposal to the administrator, might realise that those types of transactions could be attacked. Obviously, it is usually in the best interests of everybody, if there is a possibility of a proposal, for that to go through. The administrator might have a bit more leverage in getting a better deal for the creditors in some circumstances.

Administration is being abused in some situations, but that is not unusual. Most procedures are going to suffer some sort of abuse, but from what I can gather—it was certainly the case before I left Australia and is since I have been here—the procedure is working well. One of the plaudits for it is the fact that the United Kingdom last year decided to change its Insolvency Act to refine its equivalent to voluntary administration, so it is going to be similar to the Australian model.

Another matter which you raised in the issues paper is voidable transactions. I would like to speak firstly and mainly on uncommercial transactions. It was proposed by one submission you received that it should not be necessary for a liquidator to establish that the company was insolvent at the time that an uncommercial transaction was given prior to the liquidation. I have long held this view. I wrote an article in 1996 in the *Australian Law Journal* taking this position. It has always seemed to me to be rather anomalous.

The section that deals with uncommercial transactions is 588FB. It effectively replaced section 120 of the Bankruptcy Act when the 1992 act came into being. Section 120 of the Bankruptcy Act did not require the trustee in bankruptcy or the liquidator to establish insolvency. The present section 120 of the Bankruptcy Act, which was amended in 1996-97, does not require insolvency. So it is a little difficult to see why it was introduced. I can see the argument for insolvency being required for something like a preference because there is an intention to equalise what the creditors get. It is only when insolvency occurs that that should be done. But with uncommercial transactions what one is dealing with is what I term ‘debtor misbehaviour’ where the debtor company—the directors, usually—is trying to get property to an associate or a relative at less than market value. It seems to me that the issue of insolvency really should not come into it because these types of transactions should be thwarted. They are serious breaches of the whole corporate set-up.

Statutory demands were mentioned in your issues paper. Some of these things were raised in my article, which was footnoted in your issues paper. As you are probably aware, statutory demands are used frequently in Australia as a precursor to the initiation of winding up proceedings to establish deemed insolvency of the debtor company. The regime was overhauled in 1992 and came into force in June 1993. It was done to facilitate the winding up process and to save time for the courts when they were hearing winding up applications. What used to happen was that at the winding up application the debtor company would take issue with the statutory demand that was served prior to the winding up application and there was often an argument in court by the two parties as to whether the demand was effective or not. The 1992 act tried to resolve this situation by providing almost a pre-application hearing of a statutory demand if there was a problem.

That was a rather laudatory approach. There were problems at that stage with the pre-1992 procedure because there were basically two approaches championed by courts in different jurisdictions. This led to all sorts of uncertainty and I think that was more of a problem than the actual procedure. It was more a problem of courts from different jurisdictions making different decisions, which has tended to blight the corporate law area. But that has been changed somewhat by a decision in the 1990s by the High Court which made it clear that courts in one jurisdiction should not differ from courts in other jurisdictions unless they felt it was a blatantly incorrect decision.

Going back to statutory demands, the procedure and scheme that has been set up has caused certain problems in that a huge number of cases have been heard since 1993. There has been a stream of cases since this year. I would imagine that this is the area that has attracted the most litigation since 1992 and it has produced a rather tangled mass of case law. In an article in 1998 I tried to dissect it somewhat, to analyse and synthesise it, and that was a very difficult job. Essentially, the present scheme has now got bogged down in its own technical problems, some of which resulted from the 1992 amendments.

One of the main problems facing creditors prior to 1992 was that the courts construed the statutory demands very strictly and if there was a minor mistake in the demand they would throw out the winding-up application. Since 1992 the courts' approach to demands has changed. Courts are more liberal in their construction of demands now. If the pre-1992 procedure were in place now, I wonder whether the courts' approach to demands would be a problem. That procedure applies in the United Kingdom and does not seem to have been subjected to a lot of litigation.

The one thing that has helped with the interpretation of these demands and whether they are effective is the introduction of the Corporations Law Rules in 2000, which basically means that all the courts in Australia are applying the same rules. There still remain a lot of cases and all sorts of problems. One of the main problems is that the debtor company disputes the amount claimed in the statutory demand, saying that it is either totally or partially incorrect, and that leads to an argument in court. It is very difficult for a court to have to deal with that dispute without going into the merits of the particular debt being claimed.

One of the things that would resolve that is to adopt a procedure in personal insolvency with bankruptcy where the equivalent of a statutory demand is a bankruptcy notice and before issuing that one needs a judgment. If you have the judgment of a court already, it is very difficult for the debtor to argue that there is no debt. So that might overcome that situation. It would mean that

the statutory demand would not be used quite so much. I guess this proposal would not find a great deal of support from debt collection firms, creditors and some solicitors on the basis that payment would be delayed somewhat while you have a judgment against the debtor. The Harmer committee did not think such a requirement was justified, although the committee did not have the benefit of hindsight of seeing how the statutory demand procedure has caused problems.

Another approach to resolve this statutory demand tangled mass of litigation, and something which I suggested looking at in 1998, is to give the courts powers to make directors of debtor companies liable for the cost of proceedings where their companies clearly do not have a genuine dispute and are just trying to raise this as a way of putting the creditor off taking up the winding-up proceedings. Following on from the Harmer committee I suggested giving the lower courts the power to deal with the statutory demand issues. I understand that the Federal Magistrates Court, which was only created in the last few years, does not have that power because there is judicial opposition to that, but that might at least free up some of the litigation in the superior courts. There would probably still be quite a few cases coming up before the courts.

I notice from the issues paper that the committee was interested in the issue of unitary legislation; that is, abolishing the situation where we have a Bankruptcy Act and a Corporations Act—the latter dealing with corporate insolvency provisions—and having just one piece of legislation. I have long been an advocate of that approach. There are several advantages in introducing such a scheme, although I recognise that there are difficulties in achieving it. The South Africans have shown that there are difficulties in putting it into place—although Australia has certain advantages over South Africa in dealing with the issues because the South Africans have had to deal with some issues with respect to Roman law, which comes from the Dutch influence in South Africa.

All in all, in Australia, while there are some disadvantages, I think that the advantages outweigh them. I think it is preferable to have a single system, because it fosters harmony rather than divergence. I think we have divergence with the bankruptcy and the liquidation systems, for example, when they are really very similar. I have set out my views in the paper that was referred to in your issues paper. I will not repeat them, but I will answer any questions that committee members might like to put to me.

The last thing I would mention is the issue of unfair preferences. I raise this because it came out of evidence that was given to you by a former colleague of mine, Rosalind Mason. I will just mention this briefly. It may be something that the committee wants to look at or it may not be. I know that you are looking at the avoidance provisions. I refer you to the uncommercial transactions section earlier in my address. The issue of unfair preferences is something that has exercised my concern for some time. I think that the Australian legislation is reasonably good as far as preference legislation goes. I think it is far superior to that which applies in the United Kingdom, where a liquidator has to prove that a debtor company had some sort of subjective intention of giving the preference. That has basically killed the preference law in the United Kingdom. It does not have to be proved in Australia.

I have advocated that the preference law could be made more efficient, fair and effective by essentially bringing in a type of strict liability. I have argued that, whilst the present system is sound in many ways, it does not meet the rationales for the avoidance of preferences, which are basically to bring equality to the creditors and to deter companies from being dismembered.

Those rationales were set out by the full Federal Court in the case involving Ferrier and Southern Cross Airlines in about 1990. At the present moment, if a person receives a payment from a company before winding-up and the liquidator comes to that person and says, 'I want the money back because it was a preference,' that person has a defence under the Corporations Act, section 588FG, which basically provides that, if he or she received it in good faith and was unaware of the insolvency of the company at the time, they can keep that preference.

I think that is a problem because, with preference law, you are trying to equalise the amount that creditors actually receive from the winding-up. It seems to me to be unfair that a person can hold onto a payment in that situation. There are several problems with the legislation and I will not go into them in depth. But at the present moment we have a situation where—and we can take the example I just gave you of somebody receiving a payment before the winding-up of the company and the liquidator saying to that person, 'I want that money back'—if the person who received a payment knows that it is a preference, there is nothing really to dissuade them from taking the money from the company. It is what I would call the 'take the money and run' principle. The liquidator may never actually find that the payment has been made because of the terrible state of the company's books and accounts et cetera.

If a liquidator does demand the money, of course the liquidator might not have any funds to pursue the action. Even if he or she does then they might not be able to actually prove the elements that one needs to prove for a good action for avoiding a preference. There is no penalty for taking a preference from a company. All you have to do, if you find the liquidator has a good case, is repay the money. You may have had the use of the money for years, but there is no penalty there. So there is nothing wrong, in one sense, with taking the preference and seeing if you can hold onto it.

To overcome that situation, I have advocated what I call an automatic avoidance, under which a liquidator could avoid any preference transaction that takes place within a set period before winding-up—and I have advocated 60 or 90 days, which is less than the present six-month period—on the basis that all the liquidator has to prove is that the date of the transaction falls within that time period, that it related to a past debt of the company and that the effect of the transaction was to give the creditor receiving the payment an advantage over the other creditors of the company or, in other words, a preference. My argument is that that would eliminate some of the technical difficulties and problems of proving a claim.

One of the things that you have heard in previous evidence is that, in establishing claims like this, the liquidator has to prove insolvency. That is not always an easy thing to establish because of the technical way that insolvency has been interpreted under the 'unable to pay debts as they fall due' provision in section 95A of the Corporations Act. The strict approach that I have advocated would overcome that technical debate about whether or not the preference should be paid. I think those are all the things I want to address at the moment. I have spoken for quite a while, so I will leave it to you to ask questions.

CHAIRMAN—Thank you very much—that was certainly a very broad ranging elucidation of a number of the issues that have concerned the committee and which, as you said, are summarised in our issues paper. I think you have also addressed some of issues that we might have asked questions about—you have addressed them in anticipation of questions. That has also been very beneficial. What is your view of the chapter 11 type arrangements that apply in the

United States? Some submissions have advocated Australia moving to a chapter 11 type system. Do you have any views on that?

Prof. Keay—I do. I have looked at chapter 11 and, with all due respect, probably not many people outside of the US would be really conversant with all aspects of chapter 11. From my perspective, there are some severe shortcomings with chapter 11. If you look at the literature on chapter 11 from both practitioners and academics, there is a lot of criticism of it. When you look at the actual statistics, I think you will find that only a small percentage of companies actually come out of chapter 11 with a positive result for creditors.

A number of practitioners and academics have pointed out some of the problems with chapter 11, and I am sure you have already come across some of those in your consideration of this issue. One of these things is the debtor in possession principle. Some people feel that you should not leave the people who have made a mess of things in control of the company. Whilst, of course, there is a bankruptcy judge who oversees things, he or she cannot be involved in the day-to-day affairs of the company. I must say that I have a concern about that. I know that there are situations in Australia where insolvency practitioners take advice from the directors of a company when they have gone into a company as a receiver or administrator, and that is something they can do—they can actually take that advice.

I think the general tradition in the Anglo-Australian system has been that the person put into the company is independent. I must say that I tend to favour that. From the cases that have come out of the United States, I think there is an indication that there are real problems with this debtor in possession situation. I know that, if a court hears enough evidence to suggest that there is a problem with leaving the directors in control, they can appoint a trustee who effectively is like an insolvency practitioner in Australia and that trustee can come in and run the company. But it is done very infrequently. That is a concern. The Harmer committee looked at this issue when they were formulating the idea of voluntary administration and they came up with many of the viewpoints that I would take.

One of the things about chapter 11 that has also caused problems is the fact that one can enter chapter 11 if a company is not insolvent, whereas, with voluntary administration, you have to be insolvent, likely to be insolvent or becoming insolvent. That is not a requirement with chapter 11, as I understand it. Therefore, companies can use chapter 11 to avoid things like tort liability, as in the famous Manville case, where the company tried to avoid liability for asbestosis, and the Dalkon shield case, where the company went into chapter 11 essentially to force the women who were suing it for negligence into taking some sort of package deal. I think there are indications that chapter 11 is being used in an improper way to try to avoid liability not only to tort claimants but also to employees who are under employment contracts that have been formulated with unions.

I think that chapter 11 really puts forward a different approach and I do not know whether Australia would be ready for that approach. It really goes very much to the American idea of the rehabilitation of companies. I think it is linked to their idea that people can go broke, to put it in common parlance, and that they should be rehabilitated as quickly as possible. As I said, I do not know whether the psyche in Australia would be quite as accepting of that principle. I think there are problems with it. The voluntary administration process is a better process, in my view, particularly because of the fact that someone independent is running the show. I think that is

appealing for creditors. As I have said already, the chapter 11 process has received a great deal of criticism and a lot of people are very suspicious of it.

CHAIRMAN—Deeds of company arrangement is another area of concern raised with the committee. The tax office has raised the concern that they are being used increasingly as a mechanism to avoid paying certain creditors. Some employees have raised with us the issue that a deed of company arrangement was used to effectively exclude them from their employee entitlements in that it prevented the government standing in the shoes of the creditors in order to make a payout under GEERS and then recoup that from the company. Do you have any thoughts on those concerns and, if you believe they are significant, on how they might be overcome?

Prof. Keay—I do not think that I could comment on that. I do not think I know enough about the practice side of things and I am certainly a little bit out of the loop at this stage. So I do not think I could comment.

CHAIRMAN—Another thing that has been raised with us is the independence of administrators. The tax office, in their submission, suggested that a roster system be introduced. The Law Council of Australia has suggested that the criteria be broadened to allow more lawyers to participate as administrators and liquidators. Do you have any views on means of widening the pool of potential administrators and liquidators and also on ensuring independence?

Prof. Keay—One of the main concerns that people have had in practice is that you can have an administrator who is not really independent in that he or she has a connection with the directors of the company or the company itself. A number of cases have been heard where this has been shown to be the case. If there is any possible suggestion of bias or improper conduct, the courts have removed somebody, but, of course, that is only where it gets to an application. In many cases, the creditors do not have the energy, time or money to actually initiate proceedings to have an administrator removed. As I said earlier, I think there is no doubt that, where you have the systems that we have, you are going to have some abuse. I do not think we can eliminate it totally. Things are a lot better than they used to be, certainly since we brought in more regulation as to who can act in this capacity.

I do not know whether broadening it to allow solicitors to take on the role would help, in many ways. I know that in the United Kingdom, where there is the possibility of not only accountants but also solicitors being licensed as insolvency practitioners, very few of them do any administrations because they find that their offices are not set up to handle that type of work. I am actually a consultant to a firm in Leeds where two of the partners are licensed insolvency practitioners but do not act in that capacity for that reason. We know from the past, I think, that with part X applications under the Bankruptcy Act, it was possible for solicitors to call a meeting of creditors of an individual and act as the trustees for a part X arrangement. I know, from my experience when I was a registrar in the Federal Court, that there were real problems with certain solicitors handling that, from a number of perspectives. So I do not know whether that would solve the problem and make it better.

I think that as far as the roster system goes it is difficult to see, without an actual proposal, how it would work. As you probably know, that was a situation that ran in a number of states, with liquidators, years ago—primarily in New South Wales, where they had a roster system. It was there not only to ensure independence; I think it also was there to ensure that liquidators got

a company on the basis of—sometimes you will get a company which is going to produce all the fees for you and in other cases it is not, you may even be out of pocket, and you just have to take the appointment. If there is some way of putting it into effect, a roster system has a lot going for it.

The argument against it, which I think has been put forward on a number of occasions, is that it means that the directors or the charge holder who actually appoints the administrator cannot select somebody who is an expert in the particular field. For example, if you had a company running a hotel business, there are certain insolvency practitioners who are very adept in that field: they understand the industry. So they could get somebody in who understands the hotel business and therefore might be able to run it better than another insolvency practitioner who has not had experience in that sort of area. I think that is probably the main reason against it. I suppose it is one of those situations where, if you allow the present situation to go on, you possibly sacrifice independence for expertise. The other way, you increase independence but you may lack some expertise, and therefore fees might go up, of course, because a practitioner might be doing certain work that a colleague who was expert in that field might not have to do.

CHAIRMAN—Another issue is the capacity of creditors to appoint a liquidator. When a company moves from administration to liquidation, it has been suggested that creditors should be given greater power to choose who should be the liquidator. Should creditors be able to appoint a liquidator when a company moves from administration to liquidation?

Prof. Keay—I think that would be a good thing. I think there is a situation where the creditors might feel that somebody new ought to come in and have a fresh look at the company. The danger, with the present system, is that the administrator takes over as liquidator and basically leaves things as they are, does not do any further investigations, because he or she has done some investigations—whereas it is quite plainly indicated, in a number of cases, that a liquidator should be investigating more than an administrator. I think that creditors should have that opportunity. I think that, in some cases, creditors would take up that opportunity.

Of course, the downside of that—and this is the argument that is often used against this type of situation—is that the administrator has already been in the company for a while. He or she knows the affairs and if you appoint somebody else then that person has to come up to speed, so you are obviously having an overlapping of costs: it increases costs. So again, it is a question of whether or not the creditors are willing to perhaps sacrifice something in the way of their dividend decreasing because of the extra costs—or to proceed on the basis that they might be able to get somebody in who finds something that the previous administrator did not find.

The argument for having a different person is also that the administrator, it is sometimes alleged, can get a little bit close to the directors—take advice from the directors, listen to the directors—and therefore he or she can become less independent over time. Of course the opposite can occur, where the administrator becomes extremely suspicious of the directors and investigates more and more, so it really is a case-by-case basis. I suppose my overall thinking would be that creditors should certainly have that opportunity but should be aware of the possible downside, which is the running up of more costs.

CHAIRMAN—Under the current law, if an application to wind up a company is pending, a board of directors can wait until the last moment before the winding-up application is heard and

then appoint an administrator. It has been suggested, again, by some of our witnesses that the appointment of an administrator should be prohibited or at least the permission of a court required for the voluntary administration to commence, when there is already an outstanding winding-up application. Could you express a view on that?

Prof. Keay—Yes, I think that is probably a good way to go. I think it gives greater transparency to the administration process; it does not look so much as if it is a shady business. When the administration process came in, the idea was that of course the courts would not be involved in the process, and that, of course, had many advantages in cutting down costs. But we have seen a large number of cases since 1993, particularly with the courts being asked to exercise their discretion—under section 447A, I think—so courts do get involved. The argument that might be mounted of: Oh, we want to keep the courts out as much as possible,' is laudable in some ways, but I think that if we take that view we sometimes sacrifice the status and the reputation of administration. I think that the proposal that you have just put forward has a lot of merit.

CHAIRMAN—That completes our questions, Professor Keay. As I said, some of the other issues about which I had some questions in mind you actually covered in your address to us, so that was very good. On behalf of the committee, I thank you very much for linking up with us this evening and making a very worthwhile and beneficial contribution to our inquiry.

Prof. Keay—Thank you. It has been a pleasure, and I wish the committee all the best in its deliberations.

CHAIRMAN—Thank you.

Committee adjourned at 6.58 p.m.