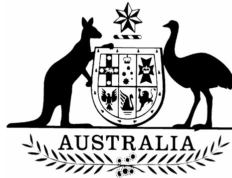

COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

(Subcommittee)

Reference: Australia's insolvency laws

TUESDAY, 11 NOVEMBER 2003

SYDNEY

BY AUTHORITY OF THE PARLIAMENT

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **http://www.aph.gov.au/hansard**

To search the parliamentary database, go to:
http://parlinfoweb.aph.gov.au

JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Tuesday, 11 November 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 and Wong

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

BASTIAN, Mr Paul, State Secretary, Australian Manufacturing Workers Union New South Wales 342

CULBERT, Mr Geoffrey, General Counsel, GE Commercial Finance 321

DREISE, Mr Anthony John, Council Member, Commercial Law Association of Australia 308

FINNANE, Mr Edmund Thomas, Member, Legislative Review Task Force, Commercial Law Association of Australia 308

GILBERT, Mr Ian Bruce, Director, Australian Bankers Association 332

GILLARD, Mr Brian James, Committee Member, Commercial Law Association of Australia 308

HARDAKER, Mr Ron, Executive Director, Australian Finance Conference 321

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy, Australian Bankers Association 332

IPP, Mr Stephen, Law Committee Member, Australian Institute of Company Directors 283

KEOGH, Dr John, President; Chair of Legislative Review Task Force, Commercial Law Association of Australia 308

KERR, Mr David John, (Private capacity) 297

LEONARD, Mr Michael, Executive General Manager, Group Risk Management, Commonwealth Bank of Australia 332

MILLIN, Mr Jon, Associate Director, GE Commercial Finance 321

TIERNEY, Ms Alison, Corporate Lawyer, Australian Finance Conference 321

UPTON, Ms Gabrielle, Senior Policy Officer, Australian Institute of Company Directors 283

Subcommittee met at 10.42 a.m.

IPP, Mr Stephen, Law Committee Member, Australian Institute of Company Directors

UPTON, Ms Gabrielle, Senior Policy Officer, Australian Institute of Company Directors

CHAIRMAN—I call the meeting to order and apologise for the late start. Today, the committee continues its public hearing program, which is an inquiry into Australia’s insolvency laws. Before we commence taking evidence, I reinforce, for the record, that all witnesses appearing before the committee are protected by parliamentary privilege in respect of the evidence they provide. Parliamentary privilege refers to the special rights and immunities attached to the parliament or its members, and others, necessary for the discharge of parliamentary functions without obstruction or fear or 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 and, as such, all members of the public are welcome to attend.

I now welcome the representatives from the Australian Institute of Company Directors. Because this is, as I said earlier, a public hearing, the committee prefers that all evidence be given in public. However, if at any stage you wish to give part of your evidence or a response to a question in private, you may request that of the committee and the committee would consider such a request to move to in camera. We have before us a written submission from the Australian Institute of Company Directors, which we have numbered 27. Do you wish to make any alterations or additions to the written submission, at this stage?

Ms Upton—Not at this point in time.

Mr Ipp—No.

CHAIRMAN—I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Ms Upton—Thank you, Senator Chapman and Senator Wong. We appreciate the opportunity to come and speak with you today. I want to do two things in a brief opening statement. The first is to explain who AICD are, what we do and how we do it. The second is to make some very general broad comments on our view of insolvency law. Those comments will probably be of no surprise to you because they are statements we have made over a period of time. We stand by those statements.

The Australian Institute of Company Directors is the peak organisation representing company directors in Australia. Our current membership is over 17,500 and is drawn from both small and large organisations from the private, public and not-for-profit sectors. Half of our membership is from small and medium enterprises, the other half being from larger companies. Our membership is on an individual basis. Our organisation is a federation of seven state divisions, and each of those divisions is represented on our board of directors. We have several national policy committees. Stephen Ipp, who is with me today, is a member of our law committee. We have an accounting and finance committee, a tax committee and a sustainability committee. Our

key functions are to promote excellence in directors' performance through education and professional development, and to initiate research and formulate policies that facilitate improved director performance.

I will make a general comment about AICD's view of insolvency law and its development in Australia. I would like to firstly say that again we welcome this opportunity and we congratulate the committee on undertaking a wholesale review of Australia's insolvency law. For some years, AICD has been urging the federal government for a wholesale review of insolvency law and, over the last few years, we have witnessed selective reviews of aspects of insolvency which have been rather unsatisfactory. There has been the CLERP 9 initiative for review of cross-border insolvency.

Australia's insolvency laws are complex, and that complexity raises the cost of doing business in Australia. This in turn creates competitive disadvantages for Australian business—disadvantages that AICD believe we can ill afford, given the globalisation of business. We are specifically opposed to insolvency laws which erode the time-honoured concept of the limited liability principle. A number of inroads have been made of late into this principle which only serves as a disincentive for people and, in particular, directors in undertaking calculated risk taking ventures. Some examples of that outside the realm of insolvency are recent legislative initiatives in the areas of industrial manslaughter, where directors potentially could be held accountable for injury and death in the workplace on a strict liability basis regardless of their involvement in the acts which led to that death or injury. More recently we are seeing that in CLERP 9 there is going to be civil liability proposed for directors for breaches of the continuous disclosure regime.

Calculated risk taking is very much a part of where the drivers for Australia's economic activity come from, and our view is that legitimate but unsuccessful commercial activity must not be penalised. If indeed there are changes that are going to flow from our discussions today and your discussions with other people who have made submissions, we would ask that the full consequences of those changes are assessed so that there are no unintended consequences. Too often AICD have witnessed piecemeal changes to the law over the period of time when we have been making representation. Sometimes these are knee-jerk responses to populist concerns. An example of that, which we have made reference to in our submission, was the Corporations Amendment (Repayment of Directors Bonuses) Bill 2002, which obviously came out of concerns arising out of One.Tel and a number of other corporate collapses. Often those changes, and indeed the changes that came from that bill, which were significant, were made very quickly with little consultation and without interested parties having a chance to fully comment and have input. Having said that, we are very happy to work with the committee to the end in achieving simpler, certain and more effective insolvency laws. This is in the interests of not only our membership but also the whole Australian business community. That is the end of my opening statement.

Mr Ipp—By way of introduction, the AICD lodged a submission dated 28 February 2003 with the inquiry. As is evident from the AICD's written submission, it chose to make comments on only a selective number of the inquiry's terms of reference—those being, the duties of directors, the treatment of employee entitlements and the reporting and consequences of suspected breaches of the Corporations Act.

I would follow on from what Gabrielle has said by making the point that the AICD supports an insolvency review that is broad based and takes into account the overall scheme of Australian insolvency law, as opposed to a review based on selective insolvency issues. The main focus of the AICD's submission has been on employee entitlements. The AICD lodged a submission with the Department of the Treasury, dated 30 August 2002, in response to the Treasury's invitation to comment regarding proposed amendments to the Corporations Act to introduce a maximum priority rule for employee entitlements. I propose to make a number of summary observations in relation to the submission made by the AICD. As a general point, the AICD believes that there are a number of adverse effects that may potentially flow from the adoption of the maximum priority rule. Those adverse effects include things such as increased finance costs for both big and small business. Further, it is possible that there may be the use of some form of artificial commercial arrangements designed to void the operation of the proposed rule. By that I mean the use of company structures whereby employees are employed by a company that does not have assets. Another way of describing that would be the quarantining of assets.

Further potential adverse consequences include the requirement for the secured lender to have to monitor the business of the company to which it has lent money so that the financier or the secured creditor has to ensure that the debtor company can meet its employee entitlement obligations without exposing the secured assets to a liquidation. This raises difficult questions as to how the monitoring is to be actually implemented and the actual cost incurred in carrying out that monitoring process. Another adverse consequence would be secured lenders taking steps to enforce their security earlier than they would otherwise have done in order to protect their security. The consequence of that is not only might companies be put into liquidation earlier than otherwise, but you are likely to have the result that more companies go into liquidation than we currently see. There is a flow-on from this. Often companies are treading a fine line between solvency and insolvency. If this monitoring cost is incurred by secured lenders and secured lenders act earlier than they might have otherwise, greater pressure will be placed on companies trading in this marginal position and they will be placed into liquidation in a situation where if this maximum priority rule had been absent they would not have gone into liquidation.

Overall, one of the consequences that the AICD considers likely to occur is that generally there will be a disincentive for secured lenders to provide finance. That will obviously have a detrimental effect on the incentive for businesses to grow. One of the technical issues of this rule that the AICD is concerned about is how one actually defines what a small business is, and I know that the inquiry has heard submissions from other parties in relation to this. We are obviously aware that there are a number of ways that you can define a small business, but that does lead to practical difficulty when a business which may have been a small business at one point in time subsequently becomes a large business. You might have the consequence that it might be in the interests of a business that is growing to actually cease to grow to the extent that it might so that it falls within the definition of a small business and avoids the operation of the rule. The AICD is concerned about how that might actually occur.

One of the oddities of the potential maximum priority rule is that, as I understand it, there is potentially an exemption for small business. It would appear an odd consequence if the exemption were to apply to small business in circumstances where it is more likely, in the context of types of companies that become insolvent, that small businesses will become insolvent. The exemption would apply to exactly the class of business that is most likely to be affected, which would call into question the operation of the rule and its so-called effect.

That is a summary of the potential adverse consequences in relation to the maximum priority rule. The second major focus of the AICD submission in relation to this inquiry was the Corporations Amendment (Repayment of Directors' Bonuses) Bill. Because that bill has now come into effect, I do not propose to make detailed comments on it unless asked to do so. That concludes my opening statement.

CHAIRMAN—I will ask at the outset: where do you think the balance lies at the moment in insolvency law? Is it about right, is it too far weighted towards creditors or is it too far weighted towards trying to recover the business and keep it going as an ongoing concern?

Mr Ipp—I would adopt your words and say it is about right. I say that because if one has a look at the statistics—although I do not have the numbers in front of me—I believe, when focusing on the issue of employee entitlements, for example, that about 99 per cent of employee entitlements are actually met. It is as a result of recent large high-profile insolvencies, which have caused a lot of public outcry, that, understandably, Australia's insolvency laws have been brought into the public focus. The AICD has consistently made the point that Australia's insolvency rules generally work very well in providing for a balance between creditors' rights and proportionate distribution to the different types of creditors in a way that does not disincentivise big business or small business.

CHAIRMAN—That is in the context of a business actually going bankrupt. My question was more directed towards where you see the balance in the scope of the current law to give businesses capacity to recover and keep going, as distinct from going into bankruptcy. Is there a need to change the emphasis there or finetune to give more opportunity for businesses to recover? If so, what might be appropriate?

Mr Ipp—It is fair to say that there are various anomalies that other bodies have pointed out in their submissions to the inquiry in relation to the operation of Australia's insolvency laws. I certainly agree with that statement. This inquiry is serving a very useful purpose, and I am not suggesting that no changes should be made. But, as a general, high-level statement, I think that things are working. With regard to the balance for enabling businesses to be rehabilitated, I think the voluntary administration regime works very well. I know there are some concerns that, for example, the deed of company arrangement process does not work, because it is suggested in some quarters that a large percentage of companies that enter into deeds of company arrangement subsequently fail and go into liquidation. I agree that that is an issue, but it is a matter of balance. It is my personal view that to destroy or alter the current regime, which I think has worked very well in the last 10 years, and adopt wholesale changes, such as US chapter 11 procedures, is not something we need to do at this stage.

CHAIRMAN—My next question was going to be about your view of (a) the US chapter 11 procedures and (b) the UK provisions, which are a little bit more flexible—they are certainly perceived to be a bit more flexible—than our provisions, and whether there is a need to move in either of those directions.

Mr Ipp—My personal view is that the US chapter 11 scheme would not be something that Australia should adopt. Obviously we have a creditor in possession regime in Australia and the US chapter 11, as you know, is a debtor in possession regime. They are fundamentally different. I think one of the important things to realise is that, if you adopt the US chapter 11 procedure,

you are maintaining control in the hands of the directors. In this current climate, where there is a lot of focus on the conduct of directors, if that were to be adopted it would fly in the face of the current flow of thought on the conduct of directors and their responsibilities. In effect, you would be handing back the failed business to the directors, which in some respects might be seen as being a step backwards in the way Australia's insolvency laws are going.

One of the other major things to bear in mind about the US chapter 11 procedure is that it requires the court to control the process, and that is a system that Australia, in a way, had prior to the introduction of the voluntary administration regime. One of the main criticisms prior to the introduction of that regime was that the court controlled the process. It was too expensive—the barriers to entry were too high—and there was too much delay. If one were to adopt a US chapter 11 procedure in Australia, you would simply bring into play all those issues again. My personal view is that I would not support that introduction.

Regarding the recent changes in the United Kingdom in particular, I know that the Enterprise Act brings into play a lot of the themes that the voluntary administration regime has in Australia. One of the significant differences between the two is the amount of time that administrators in the UK have to resurrect a company. I think that it is fair to say that a lot of detailed comment has been made on the inability of companies and administrators to resurrect a company in the current time frames provided for by the Corporations Act. I see that in a practical sense in that, as you know, there are strict timetables for holding the first and second creditors meetings and almost invariably, as a matter of course, administrators have to seek an extension to the convening period by going to court. That in itself is a built-in cost. The administrator's time and money, which in fact is the company's money, is used at a particular stage of the administration to ensure that the extension to the convening period is obtained, when the effort and time could otherwise be used to actually resurrect the company. The courts are obviously very conscious of this and are quite commercial in granting these extensions. My personal view is that it would be an appropriate thing for the legislature to recognise that as well.

Senator WONG—Are the applications to extend rarely rejected?

Mr Ipp—As a general statement, I would agree with that. They are rarely rejected.

Senator WONG—That has been my experience.

Mr Ipp—The case law on what you require to establish a convening period is settled. When approaching the courts, the practitioners know that it is not a matter of putting together a flimsy affidavit with insubstantial evidence; you have to provide the evidence and you have to jump through the hoops. The practitioners know that, so there is a recognised standard. Because of that, if legislature altered that timetable, I think it would be—

Senator WONG—What would you suggest?

Mr Ipp—I would agree with one of the submissions that I have seen in relation to the holding of the first creditors' meeting which, as you know, takes place within five business days of the appointment of an administrator. Again, my personal view is that creditors are extremely keen, once a company goes into administration, to see that somebody has taken control. A lot of emotion is involved. They want to attend some formal meeting and, if that occurs very quickly,

that often provides an environment for them to obtain information that they would otherwise not get. So I think that, although the five-business-day period is rather short—

Senator WONG—I was referring to the second meeting more than that.

Mr Ipp—I would not suggest an altering of the five business days. As far as the second creditors' meeting is concerned, I think the 28-day time period is too short and should be extended. How long it should be extended is obviously a matter of debate. From memory, in the UK they now have 10 weeks, but I would stand to be corrected on that. I know that they have a much longer time frame in which to put into play a rescue package, and I certainly endorse the adoption of that longer time frame.

CHAIRMAN—In your remarks earlier, you said that one of the arguments against the current voluntary administration regime is the number of businesses that actually finish up in liquidation and are not successful in coming out of liquidation and being maintained as an ongoing concern. Do you think those statistics are skewed a bit though? Certainly evidence to us seems to indicate that, in a sense, the voluntary administration procedure is being abused and is being used as a shorthand means of putting companies into liquidation.

Mr Ipp—I am aware of that issue. It is difficult for me to say. I have not seen a great deal of it in practice, but I am aware of that issue and I understand the reasons why that would occur. I know there are various suggestions as to how you would circumvent that—for example, by enabling a company to go into liquidation at the first creditors' meeting by a resolution of the creditors. It is difficult for me to comment on it other than that.

CHAIRMAN—Do you have any view on that proposal?

Mr Ipp—In principle, it sounds like a reasonable approach. I am not sure of the extent to which at a first creditors' meeting the finances of the company would be properly known by all concerned to enable such a decision to be made then. Some flexibility should be brought into play if that procedure were to be adopted.

Senator WONG—What detriment do you say flows from the tendency for the VA process to be used essentially as a way of getting to liquidation more quickly?

Mr Ipp—I suppose in some circumstances it is possible that the VA process is used to avoid directors being exposed to the contraventions of the Corporations Act—for example, the insolvent trading provisions and that sort of thing. It gives them more time before those provisions come into play. Other than that, I do not see a significant amount or degree of detriment in the process. It generally is a user-friendly and flexible process. A possible detriment would be time if creditors are unable to obtain the results of a full investigation and there is a possible bringing of some voidable transaction proceeding because the company remains in voluntary administration. That would be a detriment.

Senator WONG—Only for the period of the administration.

Mr Ipp—Yes.

Senator WONG—But I suppose things would happen in that time frame which would alter the creditors' position. I suppose that would be the argument.

Mr Ipp—Yes. The creditor may want instant justice and, by adoption of the VA process, to a certain extent that would not occur during that time frame. Obviously what is said to be occurring, because I cannot say I have seen a lot of it in practice myself, is using a model for an unintended consequence. So how that should be changed, I am not sure.

CHAIRMAN—This morning I was speaking at the business turnaround conference that is on here in Sydney at the moment. In question time one of the suggestions put to me was that there was a need to provide greater protection for turnaround professionals who would go into a company, perhaps prior to it entering into a voluntary administration period, in an attempt to turn the company around. The danger that is perceived there is that, in doing that, they may become regarded as shadow directors and become liable. Do you see any need for protection and, if so, how would you protect those sorts of people from actions in that regard as against the regulations and provisions that apply to normal directors, as it were?

Mr Ipp—I think there is obviously a great risk that turnaround professionals could be considered as shadow directors. The only way I see around that is by providing some form of immunity, but I am just not sure how that immunity would operate. I do not see how a turnaround professional would be in a different position to that of current controllers, receivers or administrators. I would expect them to have the same duties and responsibilities.

Senator WONG—But they do not under the current legislation. Administrators have immunity for a range of policy reasons, including that there are certain duties and obligations that apply to them. In the absence of those, why would we want to set up a separate immunity regime for pre-administration administrators—which is essentially what we are talking about, is it not? Wouldn't we want to just continue with the current VA process?

Mr Ipp—If a policy decision is taken, for example, that a turnaround professional does add an important component to rehabilitating a company then I think one should look at how to protect those persons.

Senator WONG—So an a priori decision has to be made, I suppose.

Mr Ipp—Yes.

Senator WONG—Surely though that is the idea behind having an administrator?

Mr Ipp—Yes, it is, but that raises another interesting question which I know is before this inquiry—that is, when do administrators actually come into play? Often they come into play when it is too late.

Senator WONG—But that is an issue about the practice; it is not a legal issue, is it? Legal issues flow from it, but that is an issue about when directors choose to place a company in administration and that is an issue about culture and business practice; it is not an issue about the actual regime.

CHAIRMAN—It could be a consequence of the regime, could it not?

Mr Ipp—Yes.

Senator WONG—How is it a consequence of the regime?

Mr Ipp—I would be interested in your view as to how you thought that could be a further consequence, and then I will elaborate on that.

CHAIRMAN—It is in the sense of the current regime perhaps not providing sufficient incentives for early intervention and directors leaving it, as it were, to the last minute before they go into VA which, as you said, often means it is too late for any effective rescue to be mounted.

Mr Ipp—Yes. I think Senator Wong is saying that that is a practical consequence. I am trying to understand the question that you raise in relation to the legal consequences of that.

CHAIRMAN—I was perhaps suggesting—and this is what I want help on—that it is the legal framework that in fact leads to that practical outcome, is it not?

Senator WONG—Does the legal framework work against early intervention? I think that is what we are struggling with.

Mr Ipp—Yes, it does. The reason for that is the process by which administrators are appointed—the precise point in time at which they are appointed. That goes to the heart of the question: when is a company insolvent or when it is likely to become insolvent?

CHAIRMAN—So it is that definitional issue as to insolvency?

Mr Ipp—Yes. I appreciate that there are competing views as to whether or not that timing should be altered, so I think the crucial wording is ‘likely to become’. If you lower the threshold, an administrator can be appointed at an earlier time.

Senator WONG—That intuitively makes more sense to me than creating a separate regime of providing immunity to turnaround professionals.

Mr Ipp—It certainly would be more practical. I was not aware of the idea that you raised this morning about a special regime for turnaround professionals; that is the first I have heard of it.

Senator WONG—What sort of test are you talking about? Is there any formulation you might propose for an alternative test that might encourage an earlier decision to place the company’s affairs in the hands of an administrator? If directors are not interpreting ‘likely to become insolvent’ in a way that leads to the regime being utilised for earlier intervention when appropriate, is there an alternative formulation you might propose?

Mr Ipp—The first point I would make is that, if you were to consider altering that regime, then the Corporations Act should adopt a clearer definition of ‘insolvency’. I know that point has been made to the inquiry before. I think that is the starting point. The current test as it applies, as

you know, is a cash flow test. As to how the wording should be changed, I do not have a precise wording that I can offer today.

Senator WONG—No, but what would be the objective, the principle? If you want to take it on notice, please do. It is an issue that has come up a number of times, and I would be interested in your views about not so much the actual text of the amendment but what sort of formulation you think would be useful.

Mr Ipp—Yes.

Senator WONG—Also if you have views about why the cash flow definition of insolvency is problematic, perhaps you should articulate them.

Mr Ipp—Thank you; we will take that on notice.

Senator WONG—Ms Upton, there are a number of things you have said on which I have different views, so I think it is good if I put them to you so we can actually join issue on them. Firstly, at a broader level, is the principle of limited liability. I should start by saying it is probably one of the great legal notions that Victorian England, I think it was, has produced. Clearly it is a very important vehicle for investment and for economic advancement. I note your comments that your organisation is opposed to any inroads into the limited liability principle. You made reference to populist pressures and to the detriment that these inroads cause to calculated risk. I would make a couple of comments about that. What we are talking about with the notion of calculated risk, certainly in relation to some areas such as employee entitlements or health and safety issues, is a risk that is not solely borne by directors; it is risk of injury—I do not want to be distracted too much by the industrial manslaughter issue—or a risk of loss of legal and minimum entitlements.

I start at the basic point that I do not accept that the parliament should simply leave this notion of limited liability as an immune area. The reason that there is community concern about an issue such as employee entitlements is not that it is a populist issue. It is an issue of genuine anger that there are some directors—and I absolutely accept that these are the minority—who have essentially risked other people’s money, not their own. It is in response to that that there is significant community concern about an issue such as employee entitlements. Perhaps we should just disagree. I do not know whether you want to comment.

Ms Upton—I accept what you say. Our position would be that this is a paradigm of legal principle that has borne a number of advantages for the development of Western civilisation—to put it as high as that.

Senator WONG—Undoubtedly; some say it is beyond the wheel in terms of its significance.

Ms Upton—We realise that there are pressures on governments to sometimes come up with quick fix solutions to issues that maybe, as you admitted, are not the norm in terms of company practice and the manner in which directors are exercising their duties and taking their responsibilities. There are going to be exceptions. My comment was more around the fact that it is sometimes those exceptions that lead to a response that maybe is not well thought out at times. That has impacts for the greater majority of directors and companies who—in our

understanding—do comply with the law, do take their duties very seriously indeed and do ensure that employee entitlements are provided for and fully funded. They monitor, allow and oversee the set-up of safe workplaces.

I am not disagreeing with you that there are instances at the margin where there are people who will always break the law whether it is tightened or not. It is more a suggestion, I suppose, that when decisions are taken to make inroads into some concepts that seem to have been of great advantage to us all that we consider what some of the unintended consequences of that may be. For example, it may mean that directors are not willing to step forward and remain on company boards. It may mean that people are not putting their hands up and not serving as directors on boards. It may mean that boards get tied up very much in monitoring and not focusing on the role that is at the pinnacle of their responsibility, which is focusing on strategy and ensuring that management put into effect that strategy.

Senator WONG—Hold on, Ms Upton. On the issue of employee entitlements, we are talking about ensuring that people are paid their minimum legal wages and annual leave. As I understand it, under the government's proposal it would not include severance pay. I think that is right, isn't it?

Ms Upton—That is right.

Senator WONG—So we are talking about pretty minimum, basic level costs of doing business. If the majority of your members are, as you say—and I accept this—people who would properly monitor and make provision for those legal entitlements, then what do they have to fear from a regime that puts in place measures to try to ensure that those entitlements are fully funded? I think the maximum priority issue has some different consequences. I do want to discuss those with you, but we will put that to one side for a moment.

There have been various proposals put to us, including that directors report to employees annually on the provisioning for such entitlements—both accrued and contingent; and I accept that there are different issues attaching to each of those categories—and that they make a statement that there is adequate provisioning for them and become personally liable if that statement is found to be fraudulent. You could have it at different levels; you could have a higher test or you could simply say it was inaccurate. I think you would have to have a reasonable person test there or something like that.

Ms Upton—Are you suggesting a new obligation on directors?

Senator WONG—That is one of the things that has been put in submissions to us.

Ms Upton—That the directors sign off on there being adequate provision for entitlements?

Senator WONG—Yes, adequate provision for entitlements.

Ms Upton—I do not think we are disagreeing with one another. In my opening comments I was sounding a cautionary note that we recognise—from our experience at AICD—that often the changes are made because of specific examples.

Senator WONG—A political crisis that has to be dealt with?

Ms Upton—Yes, that is right.

Senator WONG—I appreciate that. We are not in that context right now, obviously.

Ms Upton—There would be consequences from that that will be borne by the greater majority. That is borne out in monitoring costs and it may be a distraction from the role of the board. Is your question about whether we would have an issue with directors having to sign off?

Senator WONG—Essentially, yes.

Ms Upton—I would have to take that question on notice because AICD has not considered that as an issue.

Senator WONG—Do that, if you could. It might be that you would consider that a lesser evil than maximum priority.

Ms Upton—We would have to weigh that up because we can only respond, as Stephen has talked about, to the whole idea that it would sit ahead of fixed charges—

Senator WONG—I want to get to that because, despite my views about this issue, I think that there are some potential unintended consequences that this committee should explore. The proposal, as I recall it, is that the employers be required, within annual reports, to provide details of provisions that are made for both accrued and contingent employee entitlements, and that if they assert there is adequate provisioning but there is not, they then become personally liable for those employee entitlements. I ask that you consider that. In the context of that consider whether you just have a blanket opposition per se or you would consider also different rules applying to accrued and contingent liabilities—I think there is a reasonable legal argument for that to be the case—and what sort of test should apply. My view is that it might be that you would want a similar reasonable person test: if a director made the assertion in good faith I think there is a pretty reasonable argument that she or he ought not be held personally liable in those circumstances.

Ms Upton—What would be the consequence of a breach of that duty? Are we talking about civil liability?

Senator WONG—I cannot remember what the submission said.

Ms Upton—Who made that submission? What organisation made that submission—so we can go back and find it?

Senator WONG—The proposal has been made in a couple of submissions: the ACTU and I think there was an insolvency practitioners group that made that submission. It might have been orally submitted. The secretariat will identify that and get the information to you.

Ms Upton—We are happy to respond on notice about that.

Senator WONG—It seems to me that that goes to the issue you were talking about: if people are doing it properly most would have little to fear from that. That is obviously a decision for you. I will turn now to the maximum priority issue. Your assertion—it is not unfamiliar to us; it has been made a number of times—is that one of the potential detrimental consequences of a maximum priority regime is an increase in the cost of finance. Do you have any evidence to back that assertion up?

Mr Ipp—As far as I am aware, we do not have any empirical evidence of that. I think it is fair to say that we rely to an extent on what the ABA has said, in that they would be better placed first up to make that statement. I am aware of what the ABA has said as a matter of principle, and I think the AICD has adopted that view.

Senator WONG—The priority already exists, does it not, in relation to floating charge creditors?

Mr Ipp—Yes.

Senator WONG—Why do you say that applying it also to fixed securities is going to have such an impact?

Mr Ipp—I think it is fair to say that financiers look to obtaining as much certainty as possible. At the time they were agreeing to advance credit, and they achieved that through a fixed charge over an identifiable asset, as opposed to a floating charge. So its potential ramifications are far greater because of that—the financier will look most importantly at the fixed assets of the debtor company.

Senator WONG—The issue about creative corporate arrangements to avoid liability if this were to be put in place—and I think there is pretty good evidence that certain companies are prepared to make those—is something that ought to be considered carefully. What do you say about putting in place a regime which allows the corporate veil to be pierced in respect of arrangements which are clearly for the purposes of avoiding such liabilities?

Mr Ipp—We would have to take that on notice.

Senator WONG—Do you have any comments in relation to phoenix companies?

Mr Ipp—I can only repeat that I am aware of the suggestion that directors be banned. I am not sure if it is for a short, temporary amount of time or it is a permanent ban if they are directors of companies that have failed three times, or something like that. Again, we would prefer to take that on notice.

Senator WONG—Your organisation does not have a view on that yet?

Ms Upton—Not one that we have expressed publicly.

Senator WONG—Very well put, Ms Upton.

Mr Ipp—As a broad statement, we would agree with the suggestion that ASIC be given greater funding to review and police that issue.

Senator WONG—Which issue?

Mr Ipp—Phoenix companies.

Senator WONG—Would you have to increase the powers they have?

Mr Ipp—I know that the ASIC submission to this inquiry has looked at the issue of phoenix companies, probably in more detail than anybody else. As I recall, the nub of their submission was that far and away the issue of phoenix companies in practice is not as bad as it is perhaps made out to be when they look at the numbers. The offences that are actually occurring are not as serious as they might appear.

Senator WONG—It might be that some of the people have been burnt by them.

Mr Ipp—Obviously.

Senator WONG—I do not think it really helps to tell people that we actually only import one per cent. Finally, I think you have covered in your evidence today the issues I had about whether chapter 11 was a useful alternative to our current VA scheme. Are the views you are expressing the views of your organisation or your personal views?

Mr Ipp—They are my personal views.

Senator WONG—Does the institute have a view about what it would say to a chapter 11 type scheme?

Ms Upton—In terms of where the balance should be?

Senator WONG—Should we include a debtor in possession regime, either as an adjunct to or instead of the current voluntary administration scheme? We have some more evidence to hear but, at this stage, I think Mr Ipp's comments about some of the criticisms of the American regime are pretty cogent. It is some time since I studied Corporations Law but, as I recall, some of the criticisms in place were directed at the regime we had prior to the introduction of the Corporations Law and the VA scheme.

Ms Upton—We will take that question on notice because I do not believe we have any public pronouncements on the issue at all. We have had discussions but not to the point where we have formulated policy and actually pronounced it. So we will respond back to you on that if would you like us to.

Senator WONG—We covered the issue about whether there might be some benefit in having a lower test in the Corporations Law to enable an earlier appointment of an administrator, and you are going to come back to us on that. Thank you for your help.

CHAIRMAN—My only other question really relates to the phoenix company issue, which you have taken on notice. I guess the issue I wanted to explore with you is what sanctions should be applied to directors who engage in that activity, but you are taking that on notice.

Senator WONG—I think their nods mean that!

CHAIRMAN—There are no further questions, so thank you for your appearance before the committee. Your evidence has certainly been very useful.

[11.38 a.m.]

KERR, Mr David John, (Private capacity)

CHAIRMAN—Welcome. Do you have any comments to make on the capacity in which you appear before the committee today?

Mr Kerr—I am appearing in a private capacity, although I am a partner with RSM Bird Cameron Partners chartered accountants.

CHAIRMAN—The committee prefers that all evidence be given in public, but if at any stage you wish to give your evidence or answers to questions in camera you may request that of the committee and the committee will consider your request. The committee has before it your written submission, No. 6. Are there any alterations or additions you would like to make to your written submission at this stage?

Mr Kerr—No.

CHAIRMAN—I now invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Mr Kerr—For the past six years I have been on the IPAA state committee in New South Wales and I have been involved in the development of best practice statements in respect of the content of administrators' reports and the most recent statement of best practice regarding the independence of company administrators. So I guess my interest has been more in regard to the voluntary administration provisions and their application.

CHAIRMAN—Thanks very much. Your submission is very detailed and is useful to the committee. The issue is where the balance lies in the current regime—between the rights of creditors on one hand and the very laudable aim of regenerating a business or keeping it going on the other. In the current legislation, where do you think the balance lies? Do you think it is too far weighted towards the rights of creditors and does not give enough cognisance to the desirability of trying to regenerate a business, is it about right or is it too far the other way?

Mr Kerr—It would appear to be about right, in my personal opinion. However, I did mention in my submission some comments that were made very early on in the piece—I think it was in respect of some hearings about the Corporate Law Reform Act—and which were originally raised by McGuiness when he was talking about the object of part 5.3A. From a practical perspective, many insolvency practitioners have utilised the object of part 5.3A to argue that it is principally to rehabilitate a company, whether or not it provides a better return to creditors. I think that both of the objects should be read in conjunction with each other. If any legislative change is needed it should be clarified that, really, rehabilitation for the sake of rehabilitation only is not necessarily the proper aim of the legislation. I think that ultimately the stakeholders, being the creditors, should be provided with a better return from the administration than simply keeping the business going.

CHAIRMAN—Do you see any advantages for Australia in adopting a debtor in possession regime similar to chapter 11 in the USA?

Mr Kerr—I think the debtor in possession concept is something that is fundamentally alien to the Australian insolvency industry in that, traditionally and historically, we have always had an independent insolvency practitioner involved in the process. The closest thing that we have to a debtor in possession regime or chapter 11—which could I guess be modified to apply to larger corporations; I think it is discussed in a bit of detail in the latest CAMAC discussion paper—is the scheme of arrangement provisions which, in a larger corporate restructuring—which from an Australian perspective chapter 11 falls into line with more—gives the opportunity for classes of creditors to be formed. The voluntary administration provisions at the present time do not provide for classes of creditors to be considered, and each particular group of creditors may have specific interests in the future outcome of the insolvency administration.

For example, employees obviously have an interest in retaining their jobs. So if a proposal is put before them that provides for continuity of employment, such as the recent Pan Pharmaceuticals situation, obviously the union and the employees are going to support that sort of proposition, notwithstanding that the ultimate return may not necessarily be greater than the ultimate return unsecured creditors would get from an immediate winding up. But as far as a debtor in possession regime goes, I certainly would not say that I am a firm supporter of it. I think it is alien to Australian insolvency concepts. However, I am willing to be convinced otherwise.

CHAIRMAN—What is your view of the UK corporate voluntary administration procedure in comparison with ours? Does that have any advantages that our system lacks?

Mr Kerr—I am not fully familiar with the UK system, as it has undergone some pretty recent changes. My understanding of those changes is that they were more along the lines of the Australian system. The previous system was not working all that well, so they went through a reform process which has adopted many of the concepts, I think, from the voluntary administration regime here in Australia.

CHAIRMAN—What I perceive to be the main difference is that the arrangement can be entered into before a company gets to the stage of being insolvent or unable to pay its debts.

Mr Kerr—Part 5.3A does not necessarily apply to a company that is insolvent. Directors can appoint an administrator to a company under part 5.3A if they suspect that the company may become insolvent. How far you push the interpretation of ‘may’ is an important issue. I noticed that there were some submissions which were suggesting that there should be a right to appoint the administrator to a solvent company. But the appointment of an administrator is a pretty major impediment on the company and a total regime change effectively from the directors to the administrator controlling the operations of the business. So it is certainly not something directors would look upon lightly. If in fact the ability were given to a solvent company to appoint administrators, I do not think it would be something that would be acted upon on a whim and a prayer; it would be something that they would consider very carefully because of the ramifications of it. I certainly would not object to it being extended on that basis.

Senator WONG—The provision already exists where directors can make such an appointment on the basis that they think the company may become insolvent. The suggestion that has been presented to us in evidence is that people tend to wait until the last minute before they do so. Do you think that is less a function of the actual statutory formulation and more a function of the practices?

Mr Kerr—I personally think it is more a function of the practices of the directors. Company directors are entrepreneurial. They are out there taking a risk and they will always look optimistically at the opportunities to get themselves out of the difficulties that they are faced with. As I said, appointing an administrator is something that really is the last resort choice that they would make. They would not take that decision very lightly.

CHAIRMAN—A number of our submissions have commented on the positions of secured and unsecured creditors and their relative rights. It has been suggested that secured creditors have a preponderance of rights, particularly with regard to influencing the procedure under a VA or a liquidation. What is your view on that issue?

Mr Kerr—Effectively, it is a matter of commercial negotiation, isn't it? A secured creditor has been in a position where they have been able to negotiate additional rights via the contract that they have entered into with the company. The legislature has, I think, been very hesitant to intervene in freedom of contract historically. Whilst there are probably some complaints that secured creditors hold too much sway, in most cases it is the secured creditor who has the greatest amount of exposure and they have been lucky enough to be able to negotiate a position that is improved upon from an unsecured creditor's perspective. The only contrary argument I would put to that is that employees do not have a choice at all in incurring credit with the company due to the fact that their obligations accrue via statute or otherwise.

I think the balance is just about right in the current voluntary administration process. With respect to the 10-day decision period, although I think the submission by the Bankers Association was suggesting that they should have a little bit more time, I think that most banks are fully equipped to deal with coming to a determination as to whether they want to appoint a receiver within that 10-day decision period, and I do not think there is really any need for any change.

CHAIRMAN—Which leads me on to my next question, which is about the capacity of the senior secured creditor to override the voluntary administration procedure. Do you think that the senior secured creditor should be bound by the VA procedure or should they retain that right within that 10-day period to enforce their charge over the assets?

Mr Kerr—My view is that they should retain the right to enforce the security. Obviously they have to be comfortable with the insolvency practitioner and the direction that the insolvency practitioner is taking with regard to the fate of the company. It is effectively the creditor's secured assets—the debtors, the trading stock et cetera, subject to the floating charge—that the administrator is potentially eroding whilst operating the business. If the administrator is not in fact looking after the interests of the secured creditor during that time, the secured creditor's position could be detrimentally affected during that decision period. I think they have to have an opportunity to appoint somebody over the top if necessary.

CHAIRMAN—What is your view on the degree of independence of administrators? The tax office, for instance, have raised with us their concern that public confidence in the voluntary administration process may be being undermined by a perceived lack of impartiality. Is that purely perception or is it fact, and either way how can that be corrected?

Mr Kerr—I think it is more a perception problem. I think that the majority of insolvency practitioners look upon their statutory obligations very seriously. However, in the current environment—and I think I allude to this in my submission—there is a very competitive market and insolvency practitioners are using all sorts of forms of marketing and techniques to obtain appointments. You have some insolvency practitioners running call centres, contacting directors of distressed companies. You have correspondence going out to directors from insolvency practitioners when judgments are entered into et cetera. I guess that sort of conduct brings into question whether or not the appointments that are being made by directors in financial distress are the right ones. This could be regarded—quite rightly—by some as sour grapes on the part of those practitioners who are not getting the appointments, but I think the credibility of the voluntary administration process, like the entire set of external administration processes available under the Corporations Law, is dependent upon the perception and the actuality of the external administrator's independence.

I think there are certainly some loopholes in the present legislation, in that the provisions dealing with inducements do not deal with inducements to directors. One of the major benefits of a deed of company arrangement to a director is obviously the avoidance of a claim for insolvent trading. If in fact a company director decides to appoint an administrator who happens to have whispered in his ear prior to the appointment, 'Don't worry, buddy; you'll be right—I'll get this deed up and you won't have to worry about insolvent trading,' there is obviously a potential problem. I am not saying that that is widespread or that it even occurs, but there is a perception out there, I think, among some creditors, that that sort of thing is occurring. The question is how you get around it, because independence is something that, as you have seen with the accounting profession and auditor independence, is something that is very difficult to deal with and very difficult to police. I think the IPAA have made some major advances in respect of that by the issue of their statement of best practice. While I am one of the primary authors of that document, I do not necessarily consider that its final form is the most appropriate form for it. However, at the end of the day it is ultimately a compromise among the broad church of members of the IPAA and it was something that was finally acceptable to all of them.

CHAIRMAN—One of the reasons being put forward for the perception that the voluntary administration system is not working, in the sense of the statistics showing that most voluntary administrations finish up in liquidation rather than in a recovery of the company, is that in fact the VA process is being misused as a means for putting companies into liquidation. Do you have a view on whether that is the case? If so, does it need to be remedied and, if it does, how would you go about that?

Mr Kerr—I do not necessarily agree that it is misuse of the process. I know that a number of submissions have put forward that proposition. However, if you go back and look at what was available prior to the introduction of the voluntary administration provisions, the only option for an insolvent company was to apply to the court to appoint a provisional liquidator, which was a very expensive process, or to appoint a creditors voluntary liquidator, via the meetings of shareholders and of creditors. The problem with the creditors' voluntary process, as it currently

exists and as it previously existed was that you have a period of time whereby directors have effectively put their hands in the air and said, ‘Look, the company is insolvent. We cannot do anything further with the company, but we cannot actually get an external administrator into control of the company—to protect everybody’s interests—for 14 to 21 days.

The most appropriate mechanism, if that is genuinely viewed as a problem, is that directors of companies should be authorised to resolve that the company appoint a liquidator initially, as something contrary to the appointment of the administrator. Therefore, the insolvency practitioner would be in control of the assets immediately. That was one of the weaknesses that the VA process was seeking to remedy.

CHAIRMAN—Do you think it would be beneficial to make amendments to allow that to happen at the first meeting of creditors?

Mr Kerr—It would certainly be beneficial at the first meeting of creditors. The difficulty that you have with the first meeting of creditors is that, because of the tight time frames, you may not necessarily have a representative sample of creditors at that meeting. You are required to convene the first meeting within five business days, and simply relying upon Australia Post is not necessarily the best way to go with those sorts of notices. The turnout at the first meeting of creditors is often very low, notwithstanding the fact that you do advertise it, and some major players, particularly the Australian Taxation Office, very rarely get to that first meeting of creditors, because of the difficulties in getting notice to them.

CHAIRMAN—In your submission you advocate the merging of corporate and personal bankruptcy law. What do you see as the advantages of that? Are there any disadvantages?

Mr Kerr—I see very little disadvantage. The reason we have the two regimes is obviously based on the fact that states historically had the power to incorporate companies. The federal Constitution gave the Commonwealth the power to legislate in respect of insolvency and bankruptcy. From a constitutional power perspective, the application of a uniform insolvency act covering both corporate and personal affairs would make good sense. We faced problems due to the High Court’s decision with regard to those cases—I cannot remember their names right now—where there was a question about whether or not the Federal Court had jurisdiction to hear Corporations Law matters. All of that stemmed back to a public examination under the external administration provisions. If that legislation had been reliant upon the insolvency power under the Commonwealth Constitution we probably would not have ended up with that sort of problem occurring, whereby we had corporate law thrown up in the air for a while and people not certain as to how things should be conducted.

The processes are fundamentally the same. If you look at part X of the Bankruptcy Act and part 5.3A of the Corporations Act, you see that part 5.3A is effectively modelled on part X of the Bankruptcy Act. Bankruptcy is similar to court windings-up et cetera. I think it makes sense to put the two together. The provisions regarding antecedent transactions et cetera are all very similar, although there has been some divergence in the past few years in respect of the various provisions.

Senator WONG—I might have misheard you. On page 4 of your submission you say:

I am of the opinion that consideration should be given to formulating an Australian debtor in possession regime as an alternative to the voluntary administration process.

I thought you said in your oral evidence that you are yet to be convinced of that.

Mr Kerr—I am yet to be convinced that it will in fact work in the Australian environment. I think it is worthy of consideration, and that is why I said what I said.

Senator WONG—What are the aspects of a debtor in possession regime that you think are beneficial that are not properly provided for under our system? Is there any amendment to our VA regime which you think would provide similar benefits?

Mr Kerr—The major difference, if you have a look at the way chapter 11 operates—particularly with respect to ipso facto clauses in contracts et cetera—is that there is a wider power to create a real moratorium under chapter 11 than there is under part 5.3A.

Senator WONG—A moratorium on what? For the debts being created?

Mr Kerr—For example—and I think I pointed this out in my submission—one of the major problems that you are faced with when you are appointed to a company under part 5.3A is that many contracts contain clauses that simply allow a contract to be terminated in the event of the appointment of an external administrator. If you are in the building industry, there is no way in the world that you can keep the business trading if in fact every contract has a provision that terminates the contract. Various supply agreements may be terminated as a result of those sorts of provisions within the contracts. They are quite sound commercial clauses but that fact certainly does not help you to continue to trade in a business when you have to deal with those sorts of problems.

Senator WONG—But if we were to adopt another regime couldn't lawyers simply draft contracts which said 'appointed an administrator'?

Mr Kerr—That certainly would be possible.

Senator WONG—That would be a function of people seeking security.

Mr Kerr—That would be exactly the case. I do not know whether or not chapter 11 does provide any additional benefits in that way. I think we could overcome those with changes to our own legislation to effectively create the statutory moratorium in respect of those sorts of clauses et cetera. I think the greater benefit of chapter 11—if there is any, and I have alluded to the schemes of arrangement provisions—is the breaking down of creditors into respective classes. Under the voluntary administration provision, because of the mechanism by which it works, all creditors are treated effectively the same as unsecured creditors whether they are creditors arising under leases for real property, they are employees, they are simple trade creditors or they are contingent creditors. Under the chapter 11 process, as I understand it, they are broken down into classes like schemes of arrangement, where creditors with similar interests effectively get to decide at separate meetings whether or not they are prepared to accept a proposal. From the perspective of a larger corporation, those sorts of provisions may be more attractive to creditors.

Senator WONG—There are a number of issues that arise out of that. I assume that when you are talking about schemes of arrangement you mean what we have been referring to them as—deeds of company arrangements.

Mr Kerr—No, I am talking about schemes of arrangement. They are a part of the Corporations Law which currently exist.

Senator WONG—I am sorry, so this would precede a deed of company arrangement?

Mr Kerr—No, it would not. The scheme of arrangement is a totally separate regime. It enables companies to restructure either their debt or their equity. Effectively, many takeovers are put into place by schemes of arrangement, particularly in the banking industry.

Senator WONG—What changes to the schemes of arrangement provisions would you be suggesting?

Mr Kerr—The schemes of arrangement provisions as they currently exist do not necessarily provide a moratorium, so if you were going to change and modify the schemes of arrangement provisions you would have to be looking at providing for a moratorium on creditor claims.

Senator WONG—Is this in terms of contract termination?

Mr Kerr—It is in respect of all creditor claims.

Senator WONG—I would like to go back to deeds of company arrangements. Senator Chapman did touch on these, but I want to explore them a bit further. There has been some discussion in this hearing of discriminatory deeds, deeds which alter the priority arrangements under the Corporations Law. I think the tax office said they thought they ought not be permitted, and some employee organisations certainly said the same thing. Quite a number of practitioners to whom I put this question said that they would not seek endorsement of a deed that did alter the arrangement. But there is evidence that that does occur. Do you think that there is any merit in the suggestion that, if a deed alters the priority position of a particular class of creditor, the majority of that particular class must agree to such a deed before it can be put in place?

Mr Kerr—Personally, I would probably agree with that proposition. With meetings under part 5.3A as they are currently conducted, effectively a meeting can be swamped by a particular class of creditor. For example, it may be that one particular creditor is not continuing to trade with the business and suddenly he finds himself being put into a separate class of claims. That was the subject of a Federal Court case—Lam Soon. In that particular case the court held that the discriminatory deed was legitimate.

I think the issue of discriminatory deeds has arisen more in respect to employee entitlements. It has probably arisen as a result of the administrative direction that has come out of the department administering the GEERS whereby, if a deed of company arrangement is approved that varies the statutory priorities for employee entitlements, GEERS will not make any contribution to employee entitlements.

Senator WONG—The legal right of employees to enforce their debt is therefore, by implication, the government's, because, when the GEERS paid, it then stands in the shoes of the employees if that is abrogated in any way—that is their position?

Mr Kerr—Yes, that is correct. I think that is where the issue of discriminatory deeds has probably become more popular at the present time as far as that issue is concerned.

Senator WONG—Are they prevalent in the industry?

Mr Kerr—I do not think they are. In the majority of cases, from an employee perspective, most insolvency practitioners formulate deeds that will provide creditors, particularly employees, with at least what they are entitled to in a liquidation. If in fact they do change the priorities with respect to a deed of company arrangement, it would normally be along the lines that it would ensure they would get a better return than they would have got under liquidation, notwithstanding the change in the priorities under the arrangement. For example, in a liquidation, it may be a situation whereby the assets of the company are all subject to a fixed charge—and you were speaking about that to an earlier witness—and the proceeds of that asset would not be available to the employees under normal circumstances. It may be that either a third party or the director may make available additional funds to provide a pool of funds for the employees, which they would get under the deed of company arrangement that they would not get in a liquidation.

Senator WONG—In that situation, presumably, the affected class is likely to agree to that deed.

Mr Kerr—Yes, exactly.

Senator WONG—So you do not have any problem in principle with that notion?

Mr Kerr—No, not at all. I think the issue has really arisen more as a result of the decision of the department in respect of those sorts of deeds of company arrangement.

Senator WONG—Finally, the issue that I think you opened with, and I may have missed some of it, was this argument as to the potentially inconsistent objectives of part 5.3A: rehabilitation of the company and more advantageous realisation of assets on liquidation. I can see factual circumstances in which potentially an administrator might be caught between the two. I am not really familiar with how the case law has resolved those two aspects of the provision. I wonder if you are able to expand on why you say they ought to be amended so as to maintain as the primary focus a better return to the company's creditors.

Mr Kerr—My view is that the court cases have effectively acknowledged that the return to the creditors has to be a better return under the scheme or the deed than what an immediate liquidation would be. However, in practice, you will see that many deeds of company arrangement being proposed are justified on the basis that you get one cent extra from a court liquidation than you would in the event that the company is liquidated. Then, when you see the end result of it, it does not actually get there. So it is sold to people on the premise that that is what is going to happen, many events occur subsequently and it does not actually end up giving you the result that you hoped it would achieve. My view is that the legislation is probably too

lenient towards the rehabilitation of companies. In many cases, companies just reach their use-by date.

Senator WONG—Yes, or go beyond it.

Mr Kerr—I think that, for a company that is insolvent to continue to trade and be rehabilitated, ultimately, the stakeholders who have funded it should be getting a better return than simply winding it up if they want the company to continue to trade and risk exposure to them.

Senator WONG—So you would—

Mr Kerr—I would support the proposition of an amendment to the objective along the lines proposed by McGuiness or even in accordance with the original Harmer recommendation, in which it was a little bit more clear that the better return to creditors was certainly not a secondary objective. I think that the better return to creditors should be regarded as a common objective rather than, as some people regard it at the present time, a secondary objective.

Senator WONG—The McGuiness formulation qualifies the continuation by saying it has to be without any undue prejudice.

Mr Kerr—Exactly.

Senator WONG—What would then occur in regard to the issue that has been the subject of some discussion in this inquiry—that is, people do not go into voluntary administration sufficiently early to rehabilitate the company? If the act were amended in the way you propose, it would make sense for creditors, but what about the rehabilitative purpose, which is also important?

Mr Kerr—I do not think it would really change that. I am not certain whether the director's decision making is really directed toward rehabilitation when they appoint administrators. In many cases, the director has received a penalty notice under the tax office provisions whereby they become personally liable for the unremitted group tax if they do not appoint an administrator within 14 days. The decisions are really driven from a perspective of finally realising that they cannot go on any further. That is the unfortunate ramification of insolvency—people will not face up to the fact that a company or an entity is insolvent until they absolutely have to. Why would you hand control to an external administrator unless you absolutely had to?

Senator WONG—What changes are you suggesting in respect of the voidable commercial transaction provisions?

Mr Kerr—In respect of voidable transaction provisions, my view is that the legislation should really mirror the Bankruptcy Act as it did prior to the amendments in 1992. Effectively, prior to 1992, provisions relating to void settlements—as they were then called—and fraudulent dispositions were incorporated into the Corporations Law directly. Under those provisions, effectively a void settlement is the equivalent of a transaction at under value, and a fraudulent disposition is the equivalent nowadays of a transfer to defeat creditors. Under the Bankruptcy

Act, those provisions do not necessarily require that an insolvency practitioner prove that the party was insolvent at the time they entered into that transaction.

In bankruptcy, you effectively have a two-year window of opportunity. If there are any transfers of property at under value during that period of time, you have the opportunity to endeavour to claw them back and you do not need to demonstrate that the party undertaking the transaction was insolvent. It simply is a statement that you should not be transferring property at under value. If you then seek to claw it back within the period of two to five years, there is a defence available to the recipient of the property, if they demonstrate that the party who transferred them the property was solvent without that property. So you effectively have two different regimes—a two-year regime and a regime from year 3 through to year 5. Presently, under the Corporations Law as it was amended, you actually have to demonstrate that the corporation, when it transferred the property at under value or in an uncommercial transaction, was insolvent.

Senator WONG—Section 5F does not have a prospective test?

Mr Kerr—No.

Senator WONG—So it is not like the voidable transactions, where you ought to have known that that formulation is not used?

Mr Kerr—No, because effectively it is up to the liquidator to demonstrate that the transaction was insolvent. In other words, you have to go through a number of hoops before you get to the issue of the transaction being uncommercial. You first of all must demonstrate that it was an insolvent transaction. As I think you are well aware, demonstrating insolvency is a very fine art.

Senator WONG—What are the negative consequences of that—that maybe the third parties within the contracts would argue that they enter into a transaction in good faith and that there has to be the threshold test of an insolvent company before they ought to be penalised? What is the answer to that?

Mr Kerr—My answer is that, prior to 1992, that argument was not available to them and that it is not available under personal insolvency.

Senator WONG—Would the other argument be that we are talking about transactions where there is clearly not fair worth given in terms of consideration for whatever has been—

Mr Kerr—Absolutely. Effectively, it is an uncommercial transaction. It is a transaction that has been undertaken at less than market value.

Senator WONG—Do you know why that particular provision required the company to be insolvent before?

Mr Kerr—To be quite frank, I do not. I think it was just something that got caught up in the legislative drafting that was going on when they were putting together the corporate law reform.

Senator WONG—It was not canvassed in the Harmer report.

Mr Kerr—As I recall, the Harmer report did not propose any changes to that test.

Senator WONG—But we now have a weaker test for insolvency administrators?

Mr Kerr—For a liquidator of an insolvent company in respect of uncommercial transactions, yes. In my view, it is definitely a weaker test than we had prior to 1992.

Senator WONG—Thank you very much. It is very useful.

CHAIRMAN—Thank you very much for your appearance before the committee, Mr Kerr. As I said, your submission was very comprehensive, and that is certainly going to be very useful to us in our final deliberation. Your responses today have also been very beneficial.

Proceedings suspended from 12.16 p.m. to 1.49 p.m.

DREISE, Mr Anthony John, Council Member, Commercial Law Association of Australia

FINNANE, Mr Edmund Thomas, Member, Legislative Review Task Force, Commercial Law Association of Australia

GILLARD, Mr Brian James, Committee Member, Commercial Law Association of Australia

KEOGH, Dr John, President; Chair of Legislative Review Task Force, Commercial Law Association of Australia

CHAIRMAN—I welcome representatives from the Commercial Law Association of Australia to our hearing. The committee prefers all evidence to 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. We have before us your written submission, which we have numbered 41. Are there any alterations or additions you want to make to it at this stage?

Dr Keogh—For the record, could we just draw the committee's attention to some very minor typos. In the second last line of the first paragraph on page 4, the word 'be' should be inserted between the word 'should' and 'struck'.

Senator WONG—Can you give us the paragraph number?

Dr Keogh—It is paragraph 19. The second last line should read:

Determining where the balance should be struck …

Coming down to paragraph 21, once again in the second last line, it should read, 'have been paid'; 'been' is missing. Then the third line in paragraph 22 should read:

… 30% of funds be available …

Mr Finnane—I am not sure that is right.

Dr Keogh—Right, I am sorry—we went over that, didn't we? Yes. It was in the other. Just strike that out, if you would. Thank you.

CHAIRMAN—I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Dr Keogh—Thank you. We are fully represented here today, from directors of the CLA to members of the legislative review task force. The CLA serve the interests of commerce and law—it should be pointed out at the beginning that we reach right across commerce and law. Our members are not just lawyers; they are commerce related people as well, from accounting and

commerce generally. We have a very healthy mixture of the two, and it has been that way since the association was formed 38 years ago.

The Commercial Law Association's legislative review task force provided a written submission in June to the parliamentary joint committee, as you know. It came about as a result of submissions to the committee on these issues that you raised. It was discussed pretty thoroughly by our committee. A paper was initiated and the principal authors are here today, Edmund Finnane and Brian Gillard. They are the ones who will be speaking to it today because they are specialists in this area, but it was reviewed by the 15 members of the task force. It was then put up to the CLA board and they reviewed it as well before we signed off on it.

There have been many submissions over the years from the CLA, long before I came into the chair three years ago as president and going right back to some of the major submissions that were made to government on banking, finance and all sorts of matters. In the last 15 months we have also held issues workshops with government agencies, such as CAMAC, and also with the New South Wales Law Reform Commission on corporate sentencing—that is a particular area for them. We are very keen to serve as we can in any of those areas. The CLA hold an annual insolvency and voluntary administration seminar each year in June, and I place before you over there information on our last two seminars. I am sure I am correct in thinking you were the guest chairman at our last seminar, in June, Chairman.

CHAIRMAN—I was a speaker; I do not think I was chairman.

Dr Keogh—You were a very good speaker to begin with.

CHAIRMAN—Thank you.

Dr Keogh—It was an excellent seminar. We also have instituted a series of 'sunset debates', which add to a lively discussion in a more informal manner by being able to put a debate on either side of an issue. I was just pointing out to your committee secretary that a debate is taking place tomorrow night in Sydney—I know you will be away from Sydney, but you can see the interest that we have in this area—on employee entitlements versus directors' entitlements. That will be the subject of a lively debate, and the two protagonists should well and truly be coming from different points of view. That is all I want to say in opening our submission on this. As I say, we are keen to take any questions and to provide as much information as we can, either today or following on from this hearing as well. As I have said, the principal questions should be directed to the other three witnesses.

CHAIRMAN—Is there anything else you would like to add by way of an opening statement before we proceed to questions?

Mr Gillard—I would like to address paragraphs 1 to 15 of the proposal paper in general terms and perhaps by way of clarifying matters. The committee had formed the opinion that it is important that the law both works and is perceived to work. We essentially believe there is a potential for conflict between the roles of the adviser versus the administrator versus the liquidator. The perception of that role, and how it is dealt with, is an issue that should be considered. The major problem occurs, in our opinion, where creditors believe that there is no useful purpose in their participating in the administration. This may be particularly relevant for

relatively small creditors, in any particular matter, where they see the failure to redress actions they do not believe are in the interests of the creditors or of the company overall.

At present, the administrator is appointed by directors and it can be expected that, in such a circumstance, an administrator would be chosen in whom a certain amount of trust and a certain amount of understanding exists. On the other hand, the administrator quickly becomes an impartial expert who will examine the books and determine whether or not there is a possibility of continuing to trade, or to trade out of insolvency, subject to a deed of company arrangement or some other arrangement that might be put in place. The change in that role can sometimes be seen by creditors as the administrator in effect being the directors' man. Certainly he would be evaluating a proposal that is put by the directors, and it is very unusual for directors to put a company into voluntary administration until they have worked out how they intend to deal with the issue.

That can be further complicated. The practical experience I have had is that the directors will then go about and talk to different creditors and see how they might vote on certain matters. An example of that are the recent dealings in relation to Pan Pharmaceuticals, where there was a great deal of agitation in relation to those issues. Perceptions that are created by media reporting et cetera may further harm the way that works.

I would like to go back to the whole reason why voluntary administrations were introduced. You may recall that some years back, in the 1980s and early 1990s, a large number of insolvencies occurred. One of the identified difficulties was that directors continued to trade, even where the impossibility of trading out of insolvency should have been recognised, and would have been recognised by an expert such as a chartered accountant or somebody in the role of administrator. The problem was that they continued to trade and caused the problem to be far greater than it originally was. A voluntary administration scheme was set up to allow directors to put the company in the hands of an expert, who would give them unbiased advice about whether or not they could continue to trade or possibly even hope to trade out of insolvency. That was seen as reducing the damage that these insolvent trading problems had produced. It also gave them the opportunity—presumably, where there was some chance, if the creditors cooperated—to force the hand of creditors to cooperate. Therefore, the majority vote might remove a particular problem creditor from that position.

Because of that, the scheme was set up so that directors would feel comfortable with appointing an external party. The key to appointment was a decision or resolution by the directors that the company was in fact insolvent. Having given up that issue, there were only two ways things could proceed: either the creditors cooperated or the administrator decided that a liquidator should be appointed and the company put into liquidation. In our mind that is the genesis of the problem. You need to make the directors feel comfortable to yield in those circumstances, rather than continue trading in hopelessly insolvent fashion. The other problem, of course, is that sophisticated directors may put together schemes. They may negotiate with different creditors for voting to go in a certain direction, and that is where the problems with perception occur.

That is the background to our proposal. Some consideration should be given to having a party put in, perhaps as an acting administrator, to assist the directors in putting together their proposal and that creditors be given an opportunity at the first meeting to put up an alternative

administrator so that, where there is a perception of bias in the administrator, they can be removed quickly and inexpensively. After all, to go to court would be expensive and to have an extra meeting would be expensive. These voluntary administrations cover everything, from the smallest insolvent company to companies like Pan Pharmaceuticals, and we believe that giving the creditors this early opportunity could be to the advantage of creditors overall and to the whole scheme, such that perceptions remain that there is an opportunity for removal. That was the genesis of what we are looking at.

We note that the ATO have taken the position that this is a problem. They want to look at having impartial administrators appointed. We weighed up in our minds that there is also a need to make the directors feel as though they have some control over what is obviously a very important decision—not just for them but, in fact, for the health of the economy, in that no-one wants hopelessly insolvent companies continuing to trade in the vain hope of trading out of insolvency. That was one of the principal matters.

Some of the considerations we took into account were that administrators are, in effect, registered liquidators. They are professional people, they know their obligations and they are reviewed by ASIC. It may be appropriate that they are reviewed by a professional body. My feeling is that a lot of professionals are now being externally reviewed, and therefore ASIC may remain the appropriate body. But they are professionals, and we believe that the actual damage being done is less than the perceived damage being done. There are perhaps instances where administrators have acted inappropriately and have felt that they have had some protection through being, in effect, part of an arrangement with directors to get things through. But I think that there are other ways of controlling the behaviour of administrators. Those are the submissions I wish to make.

Mr Finnane—I am obviously open to discuss any of these matters. We have only really covered three of the terms of reference for the inquiry. Since Mr Gillard has dealt with the first item, I will deal with the remaining two. I will also say something about the matters that we have not covered. It is not out of any lack of interest in those issues. They are all the sorts of things that we in the legislative review task force would look at, and if proposed legislation is generated as a result of this inquiry no doubt we will look at it. But we have focused on a couple of issues and given them special attention because we think that is probably more productive.

Regarding item (e) in the terms of reference, which is the treatment of employee entitlements, I want to make one thing clear if it is not clear in the submission: we are certainly not in the business of advocating watering down employee entitlements or, for that matter, strengthening them. That is really a policy issue that involves broader considerations than the sorts of things that we have been looking at. We are directing our minds to the part of the submission where the mechanism for dealing with the perception that employees need some special measures to enhance their position can be addressed in more than one way. It does not have to be an all or nothing priority type of debate. We could have something along the lines of what we have proposed, which is that a certain proportion of moneys that are available after payment of liquidation expenses and so on are set aside for priority expenses such as employees and the balance is available for other unsecured creditors. An attraction of that type of regime would be that you are more likely to see liquidations where everybody gets something, which may make more people happy. Other parties who have made submissions here have made the point that employees are not the only particularly vulnerable party in the economy. Farmers say they face

particular problems. Small business people, particularly subcontractors in the building industry and so on, are also vulnerable. As I say, we are certainly not suggesting the way in which this issue ought to be resolved ultimately, because that seems to be a broader policy issue.

Item (g) of the terms of reference relates to deeds of company arrangement. Our proposal is fairly specific and is drawn from my own experience, and I am sure that others on the task force may well have had similar experiences. It is quite common that directors or related parties—normally of companies or parties that have received sums of money in the lead-up to a winding up—are asked to put something into an administration to enable a deed to be effectuated. That is probably a good thing. The main reason parties are prepared to do that is to avoid the consequences of liquidation. Providing it is not abused, it is not necessarily a bad thing that people can, in effect, settle the claim in advance and prevent a liquidation taking place by putting some money in. It also means that you do not have the prospect of a liquidator being appointed and then having to commence proceedings and go through all the costs of doing that, so there are some advantages to that happening.

I think my reading of the Corporations Act is correct in that an administrator cannot give an effective release from claims under part 5.7B. I think an administrator could give an effective release from claims that would be personal to the company—claims for breach of duty, negligence and so on—but I do not think an administrator can give an effective release for claims under part 5.7B because those claims are personal to a liquidator. They are not claims that a company has. I think a lot people probably conduct themselves as though an administrator can do that, frankly, but I do not think an administrator can.

To enact the reform that we have proposed would potentially open up administration to greater abuses. This is why it is not something that should be done on its own. If we deal with the concerns that people have about the independence of administrators—and other concerns that people have about abuse of the provisions when deeds are entered into, which we have not specifically covered, but there are concerns that are out there which are quite valid—and you have a system which appears to be working better and to address those problems, I think this is a sensible sort of reform to be enacted.

CHAIRMAN—Thank you for those enlargements on your written submission. Before we proceed to the detail on that, the Law Council have put to us that the qualifications and requirements for people to be appointed as administrators or liquidators should be relaxed somewhat to allow lawyers to take up that role as well as people with accounting qualifications. As commercial lawyers I wonder what your view is of that—not simply lawyers being advisers in this process but lawyers actually being the liquidator or administrator.

Mr Gillard—I do not think that there is anything fundamentally wrong with that situation. You have two sets of professionals. It may be perceived that in fact solicitors are more closely related and the expectations placed on them higher, but once you get to be a registered liquidator you are in effect an officer of the court. So, if an accountant steps into that role, he is going to be reviewed. The conduct expected of him when a supreme court judge gets to review his conduct is going to be as high as that expected of a lawyer, so I do not think there is any particular advantage in lawyers becoming involved in that situation.

The crux of the issue is an appreciation of your independent role. Where our submissions have addressed the conflict issues we think that that is where the important issue lies: can these people perform independently? Unfortunately lawyers tend not to have a discipline of being impartial. There is a growing body of mediators who are trained to be impartial, but lawyers traditionally take their client's side in matters and will argue either side of the coin as ably, whereas accountants may have more experience of being in the auditing role et cetera. It may be that those issues should be looked at. Certainly we are not saying that lawyers cannot do the job and certainly we are not saying that only accountants who have performed auditing roles should do it, because there are many different types of accountants involved.

The final comment would be to ask whether or not there is an appreciation of the more intricate issues at law et cetera that are involved. It may be that lawyers, with the discipline background that they have, are more able to deal with things like court challenges and more complex and difficult matters. In that circumstance a lawyer might have an advantage. But there are plenty of lawyers with accounting degrees and there are plenty of accountants with law degrees. So even there I do not think that there is any real imbalance. We see no reason why lawyers might not be involved, but, as I say, the body we are a part of has many disciplines involved as members and I do not think we will take a stand either way.

Dr Keogh—There was a suggestion that we were looking at this acting administrator idea there. Could you see a more flexible role in that though, Brian, if we—

Mr Gillard—It might be appropriate that, if a lawyer was entitled to become an acting administrator in terms of how we have presented that issue, they could be a trusted adviser. That may be a more appropriate position for them to be in.

Senator WONG—I am not sure I want to focus too much on whether or not the legal profession can expand its range of business. I do not want to be distracted by that too much. I suppose some people might say that the accounting profession's reputation for independence, even in the context of firms which have been doing auditing, has suffered somewhat in recent years. That is hardly the strongest argument you could put in relation to lawyers. I would have thought that perhaps a stronger argument would be that a law degree per se, without any additional qualifications in commerce or accounting, ill equips you for managing the finances of a company.

Mr Gillard—I think that is quite right.

Senator WONG—For me, that is a more cogent argument. But, having said that, dual degrees and additional qualifications may remedy that.

Mr Gillard—I think the touchstone of it is that you need the commercial experience to be able to appreciate the issues. Particularly in relation to being an administrator, you need to see through the proposal that the directors are making and you need to see how that affects all stakeholders in the company. You really need that commercial background.

CHAIRMAN—I want to follow up the issue of the independence of administrators. Given the proposals you have put forward, you obviously see it as a significant problem. In the course of our inquiries some have said it is a problem; some have said it is more perception than reality. I

am wondering where you lie in that continuum—whether you see it as a real problem or whether it is more an issue of perception.

Mr Gillard—My personal experience has been that it is more perception. I think Mr Finnane's position might be that it is more practical. I will hand over to him, because I have said what I need to say.

Mr Finnane—To work out how much of it is perception and how much is reality, I suppose you would have to get some statistics, and I do not know how good they would be. I can say from my own experience that I have seen some abuses of part 5.3A in practice, in circumstances where people appear to have assumed that they can appoint an administrator, do a cheap and nasty deed and nothing will be done about it. Having said that, I have also seen that, when disgruntled creditors take this up with the courts, the courts do not let people get away with much. The problem is that it costs a lot of money to go to court. I was involved in a case a few weeks ago where, effectively, we prevented a deed from being entered into and had a company wound up on behalf of a creditor. It would have cost that creditor in excess of $20,000, I imagine, to get that far. There is no guarantee that, now the company has been wound up, they will get a cent. That is the problem. So I think there are certainly actual abuses of the provisions of part 5.3A. There is also an element of perception which may well exceed that, but there are actual abuses that go on.

Senator WONG—I want to turn to your suggestion that there are a number of ways in which one could deal with the independence of administrators and how that could be encouraged or enforced by legislation. You suggest a roster system as your first proposal. We have heard evidence, which I think has some merit, saying that that is inefficient and unwieldy and, in particular, that not all administrators will have expertise in certain types of companies. A roster system does not take that into account sufficiently. There have been a number of other suggestions about how one would try to encourage the independence of administrators. Perhaps we should put those to you in due course. I suppose the first question I have relates to your second proposition about the acting administrator. It is not clear to me how that process per se will increase the likelihood of the independence of the administrator.

Mr Gillard—The issue that we are primarily addressing there is that of changing the administrator.

Senator WONG—Yes, I understand that. But why would a subsequent administrator be any better than one in the system we have now?

Mr Gillard—There are two reasons why that may assist the process. The first reason is that there are a limited number of registered liquidators around who can serve the purpose. The first administrator would have been nominated by the directors and, after they have been removed, the second administrator would be aware that there is an active creditor expectation of independence, and I think that in itself as a behavioural issue will address some of the problems. The second factor that operates in this area is the question of perception. I think that the whole system becomes weakened. I have seen creditors say, 'What's the point in my going along because of X?'—and that is not really an expectation—'It is not going to make any difference if I go along or participate.' Even more so than in a liquidation, it is important that creditors participate in an administration. Just coming back to the touchstone with administration, the idea

really is to get everyone together and make the best possible arrangement so that the company can trade out. That means that there is a return to creditors that would not be available if the company were to go into liquidation immediately. So their participation is an important part of the administration, whereas it may be less important in a liquidation, where somebody goes through and works out what the best thing to do is and does it.

Senator WONG—Two questions arise from that. Do you think one of the negative consequences would be that the acting administrator, because they are not seen as needing to be independent, would in fact be less independent than under the current process?

Mr Gillard—Quite possibly, but I think it is—

Senator WONG—And the second issue is: given that there is often a perception from, particularly, smaller creditors that there is no point because the big boys or girls will sort this out without any reference to them, is the second process of appointing either a different person or resolving the appointment of the acting administrator simply going to be in the hands of the largest creditors?

Mr Gillard—I think the first matter, which is that they may be less independent, in fact serves the purpose of voluntary administration, because that acting administrator can be very friendly with the directors. He or she can be an adviser, saying, 'This is what is going to happen, and this is the way we perceive it. But at this first meeting, if you do not come up with something that makes creditors feel more relaxed about this process, then I could be removed and replaced.' It allows the second administrator to be far more independent if that is necessary.

Senator WONG—Coming back to the first administrator, could that not possibly have the detrimental effect of the rehabilitation of the company becoming more important than the return to creditors, which I think is a tension in these provisions in any event, and because of the lack of independence of the acting administrator you could have situations where the company continued to operate in ways which would actually reduce the return to creditors?

Mr Gillard—It is possible that that might occur, provided the creditors were more relaxed about the independence issue. If the administrator becomes deceptive about his involvement or independence, there is nothing to stop the creditors later on suing him for misleading, deceptive conduct or other unsafe practices. There is a duty on that professional to act within bounds.

Senator WONG—But you and I both know, and as Mr Finnane said, legal rights are only as good as one's ability to bring them.

Mr Gillard—I understand that. However, going back to the issue, they may be less independent, but I would have thought that the more they are perceived as being less independent, the more chance they have of being removed.

Mr Finnane—Obviously our proposal is not full of a great deal of detail, but the point is that the default position is that the acting administrator would be removed. The acting administrator could try to get up a vote in his or her favour, but that would involve overcoming the automatic perceptions it would have. Something else Mr Gillard and I have spoken about—it is not in the submissions, but it is part of the mechanism that we think would assist this type of proposal—is

that you may also have to tinker with the way the voting rights are dealt with here. If the acting administrator simply needs to get up a resolution in his or her favour and has either the numbers or the dollars in his or her favour then, under the current provisions in relation to voting, if there is a deadlock the administrator would vote in the administrator's own favour. There is much to be said for administrators and liquidators having the ability to break deadlocks in general, but here you have the sort of vote that one should normally abstain from. Why not have the situation where it is either passed on both the numbers and the dollar value or not passed at all for this particular vote?

Mr Gillard—Or even something higher. At the highest level, and without purporting to take a position, you could say it has to be unanimous, for instance.

Senator WONG—What would the default be?

Mr Gillard—The default would be the roster, although you have pointed out some problems with that.

Senator WONG—Would you concede those problems?

Mr Gillard—There are problems with the roster. Rosters used to be used in the Supreme Court for liquidators, then they decided to have roster A and roster B, and then they decided to get rid of all of them—and that was for exactly the reasons that you previously raised.

Senator WONG—Some of the other suggestions we have heard to try and enhance the independence, perceived or actual, of administrators have included the administrator sending a statement of independence to creditors prior to the first meeting and the inclusion of a code of ethics in the legislation, which might have statutory force or such like. Do you have any views about those, and do you have any other suggestions? If we are not persuaded by your proposals, what other options are there to try and enhance the perceived or actual independence of administrators?

Mr Gillard—I think at the moment administrators and registered liquidators do not have a separate professional entity. They are covered by other professional bodies. The review that takes place is through ASIC, and no doubt ASIC has the ability to make decisions about good and bad administrators and registered liquidators and deal with them. In fact, I have had experience where liquidators have been suspended for six months, and having only two liquidators in the firm is a major problem for a firm—one more strike and you are out. That has changed their behaviour. I have seen that occur. I think that, when these sorts of things occur from time to time, it is not bad for that profession, so to speak. In terms of codes of conduct, we do not perceive that at the court stage there is a particular problem. I think that the courts are fairly strict with the behaviour they expect. The perception we have is that getting them to court is an expensive process, and a creditor who will take on that step without the support of other creditors et cetera is a fairly brave creditor. We see that as the problem. We are looking for other mechanisms for them to address perceived or real conflicts of interest.

Senator WONG—What if there were a code of ethics with some simpler administrative arrangement under it to make complaints to ASIC?

Mr Gillard—We would certainly support an arrangement such as an ombudsman or something which made it cheaper and quicker. There are always creditors who are very upset—it is usually a very emotional issue—and there are always creditors who make complaints which are not justified. We do not want to introduce a situation where somebody becomes very busy dealing with unmeritorious complaints, but to the same extent we see perception as a problem.

Dr Keogh—Can I give you one other aspect that has emerged that we also need to mention in terms of the acting administrator?

Senator WONG—I am mindful of the timetable. Feel free, but we may run out of time.

Mr Finnane—Some problems have been raised about the roster system. It has been noted that the court used to administer a roster system; it has fallen by the wayside. What we have proposed is a roster system—although it is not said in our submission—and it should logically be administered by ASIC, I would have thought. It might be interesting to hear what ASIC would say about their ability to do so, but one would think that because they are also involved in the administration of this whole area of law, ASIC would be on top of it and would be able to work out a workable system for doing this. That is the only thing I wanted to add.

Senator WONG—ASIC might not want to do anything further on this—they probably think they have enough to do. I have two questions in relation to deeds of company arrangement. The first, which I do not think you discuss, has been raised with us on a number of occasions and it is discriminatory deeds—that is, deeds that alter the priority provisions under the Corporations Law. Most of the insolvency practitioners who have appeared before us have indicated that they would not recommend a deed in which the priority was altered. As I understand the evidence, there is no legal reason why that could not occur. What are your views about one of the suggestions we have had, which is that if there is a class of creditor who is discriminated against under a deed the majority of that class must agree to essentially abrogate their rights?

Mr Finnane—In principle that sounds to me like a good idea, but I think that there is a real problem with discriminatory deeds.

Senator WONG—Should they be allowed at all?

Mr Finnane—I have to say that some sort of a safeguard like that would be good idea. I think the reality is that, with that sort of a safeguard, you would find that a lot of discriminatory deeds would not get up because often you find the discrimination is against an individual or a group that is clearly not going to support it. I was involved in a case recently where the whole purpose of the deed was to disadvantage my client. There was simply no other way of understanding the deed and the court agreed. With that type of safeguard, that deed would not get up because my client would vote against it. I think there should be safeguards.

Senator WONG—Do you have anything to add, Mr Gillard?

Mr Gillard—The difficulty, of course, is deciding what is actually discriminatory and what is actually—

Senator WONG—The class.

Mr Gillard—That is right, and that is always hard to legislate.

Senator WONG—If you have anything further on that, I would certainly be interested. I do not know whether you want to take it on notice in terms of having some further consideration of the detail of that.

Mr Gillard—I think that is a good idea. We are aware of the time considerations.

Senator WONG—It is an issue that has been a recurrent theme.

Mr Finnane—There is also the general power of the court to override the way the provisions of part 5.3A work, so that you could have these provisions but, if there is a discriminatory deed which should go ahead, people could still approach the court.

Senator WONG—Yes. It is a question of where the onus of taking action should lie. I have to say that I have some sympathy with the view that it ought to lie with those persons who are asserting that the priority provisions ought not to apply in the circumstances, rather than the other way around, as is currently the case. In your submission you refer to voidable transactions. What sort of factual circumstance is one looking at? Do I understand you to say that, if an administrator convinces a director to repay some proportion of moneys that might otherwise attract the voidable transactions provisions on liquidation, they should then be able to waive their right to subsequently pursue that person?

Mr Finnane—Yes, that is right. That is to say that, if you are going to settle a dispute, in effect an administrator should be able to settle a dispute that a liquidator would have settled if the company were wound up.

Senator WONG—What do you say to the argument that that is a decision which potentially can reduce the funds available as returns to creditors upon liquidation, therefore you should not be permitting administrators to do so, particularly given some of the comments you have already made about their perceived lack of independence given their relationship with company directors?

Mr Finnane—There have to be safeguards. I do not know what the association’s view in general would be, but in fact I would be against this proposal if it were simply enacted now and everything else were left the same.

Senator WONG—So it goes hand-in-hand with the administrator reforms that you were talking about?

Mr Gillard—Yes. Mr Finnane made the point earlier that it cannot stand on its own and that we would want to see the independence strengthened.

Mr Finnane—A liquidator can compromise such claims. There is nothing wrong in general terms in saying that someone should have the ability to compromise.

Senator WONG—But it is a different context, though, isn’t it, Mr Finnane?

Mr Finnane—That is right.

Senator WONG—It seems to me there are fairly significant differences between the liquidator doing it—that is essentially a decision that lawyers and their clients make all the time: 'We'll settle this for less than we think we may get at court, because of the cost'—and an administrator giving a waiver for the purpose of trying to get a bit of dough at this point in time to keep the company going. That may subsequently mean that significant amounts of money which would otherwise have been returned to creditors would be unable to be obtained.

Mr Finnane—If that release is given in respect of a small amount of money when a much larger amount of money clearly could have been got on a winding-up, that would qualify as an abuse of the provisions of part 5.3A. If somebody were to litigate, the deed could be set aside. There would certainly have to be safeguards. That is the sort of abuse that we do not want to see but, at the same time, it is something which, with the appropriate safeguards, may well enhance returns for creditors on administration.

Mr Gillard—Let us not forget what happened with Ansett and Air New Zealand. That was a liquidation that was well controlled and well publicised and Air New Zealand got away because there were commercial imperatives for the liquidator to do something. The question is whether we should legislate against the administrator/liquidator being able to face up to commercial realities.

CHAIRMAN—I wish to ask a question about secured creditors in relation to the voluntary administration procedure. Under the current procedure, the senior secured creditor, which is usually a bank, can, within a 10-day period, exercise its right to enforce its charge, effectively ending the administration. What is the view of the Commercial Law Association on that? Do you believe that it should have that specific right or should it be bound, like everyone else, by the voluntary administration?

Mr Gillard—My experience of charges and mortgages, and of the terms and conditions that are imposed therein, is that the banks usually take everything they can possibly take. I would be very surprised if they do not have other means of dealing with that. For instance, the key to voluntary administration is for the directors to pass a resolution determining that they believe the company is insolvent. A charge on a mortgage would normally have a requirement that 'you tell us if anything happens that will cause the company or is expected to cause the company to become insolvent'. So you may find that most charges reach back to an event which occurred before the voluntary administration occurred, so that there are some problems with saying to a bank, 'You can't do anything.'. My understanding of the 10-day period was that, in effect, it would cut off rights which were expected to exist, given a fair period. Given it is 10 days, they have got to either put up or shut up in effect. We have not discussed this as a committee but my feeling is that is a mechanism whereby you are withdrawing a right rather than giving a right.

CHAIRMAN—You are actually putting a limit on the banks.

Mr Gillard—That is right. Perhaps there is more of a period, but they are sophisticated creditors, so they know what their rights are. I am sure that they exercise them when and if they believe it to be—

Mr Finnane—What you have raised is heading in the direction that they have gone in the United Kingdom, where secured creditors under a fixed and floating charge simply cannot appoint a receiver, as I understand the position. They can appoint an administrator but, if somebody else appoints an administrator, they are simply bound by the administration regime. It will be interesting to see how that works out. It has only quite recently occurred there. We certainly do not have a position on that, but it is something that I am sure we would be interested, at some stage, in looking at.

Mr Gillard—Some of these charges could be very old charges. For legislation to withdraw rights, you would need to consider when that starts and how old the mortgages are—mortgages ended after this date, and that sort of thing.

CHAIRMAN—Do you have any further questions, Senator Wong?

Senator WONG—No. I do not want to get into the argument about retrospectivity on this.

CHAIRMAN—Thank you all for your appearance before the committee this afternoon. It has certainly been most valuable in terms of progressing our inquiry and the conclusions that we will be able to reach.

Mr Gillard—Senator Wong, did you want us to take the discriminatory deed issue on notice?

Senator WONG—Only if you have anything further to add to what you have said today. There was another issue. I raised with you gentlemen previously the issue that Mr Kerr raised about uncommercial transactions, and you seemed to accord with his understanding of the law. Just so we can get it on the record, do you see any difficulty in removing the requirement that, for a transaction to be uncommercial, there is a threshold requirement that the company be insolvent? As I explained to you earlier, the evidence we had this morning was that the law as it was prior to the introduction of the Corporations Law did not have such a requirement.

Mr Gillard—I would like to take that on advisement, because I have looked at section 588FB and 588FE and it seems to me that FE is adding to the relation back period. For instance, an insolvent transaction is six months, an insolvent and uncommercial transaction is two years, and an insolvent and related entity—

Senator WONG—I refer you to Mr David Kerr’s submission to this inquiry—pages 5 and 6—which deals with this issue. I would be grateful if you could consider it.

CHAIRMAN—Thank you very much.

[2.44 p.m.]

HARDAKER, Mr Ron, Executive Director, Australian Finance Conference

TIERNEY, Ms Alison, Corporate Lawyer, Australian Finance Conference

CULBERT, Mr Geoffrey, General Counsel, GE Commercial Finance

MILLIN, Mr Jon, Associate Director, GE Commercial Finance

CHAIRMAN—Welcome. The committee prefers all evidence to be given in public but if, at any stage of your evidence or answers to questions, you wish to respond in private, you may request that of the committee and we will consider moving in camera. The committee has before it your written submission, which we have numbered 41. Are there any alterations or additions that you want to make to the written submission at this stage?

Mr Hardaker—No. In fact, we have two submissions.

CHAIRMAN—Is there a second submission?

Mr Hardaker—We had a little indulgence towards the end. They are dated 11 July 2003 and 23 September 2003, and 16 September was an attachment.

CHAIRMAN—I invite you to make opening statements, at the conclusion of which we will certainly have questions.

Mr Hardaker—In our two submissions we have raised five separate issues. Four of them deal with some micro issues within the chattel finance area and the other one goes to the issue of employee entitlements, which is a broader secured lending issue. In relation to the chattel finance issues, as I said, two of them are micro issues in relation to duties of administrators. One relates to the incorporation of the law and an administrative position that is there at the moment and which is also related to controllers and the fourth is a proposal we put forward about chattel security registers.

With your permission, we will deal with the chattel finance issue second and cover the employee entitlement issue first. In our initial submission we included a generalised example of what that might mean. I have asked one of our member companies to come along today and run through a more practical iteration of how those issues might play out for the benefit of the committee, if you feel that is appropriate. As they have to be somewhere else later this afternoon, when the questions are finished they will leave. They can make their merry way out and then we will deal with the chattel finance issues. Are you happy with that?

CHAIRMAN—Yes.

Mr Hardaker—We want to hand up an example that Jon Millin will walk you through from the point of view of what the changes will mean for this middle area of the market. I will now hand over to Jon.

Mr Millin—To let you know where I fit in, GE Commercial Finance has come at AFC's request. I am from the operational side of GE's corporate lending business. That is a business which focuses on lending to the middle market, to companies that have a financing need of between $2 million and $100 million. Generally, those companies at the smaller end have approximately $10 million of sales, and that varies very widely across a number of different industries. We are principally an asset based lender, which means we focus very heavily on the fixed assets on the balance sheet. In particular, we focus very heavily on lending against debtors at up to 85 per cent of the value of inventory, plant and equipment and some property as well.

Generally, the circumstances in which we are lending and in which people require these types of facilities are growth financing, or acquisition finance because they are looking to buy companies. Often they are turnaround or restructuring companies. Generally, this style of financing does focus on companies in a variety of different circumstances. With this general mid-market section, if we talk about lending against these fixed assets, our practices under the current regime are that we do not reserve for employee entitlements where we make loans against fixed assets, which are debtors, plant and equipment and property. There was an example in the AFC's submission, and we have some other practical examples from customers in our portfolio. Obviously, we cannot talk about their names or release confidential information about them, but I have a generic case study to give you the flavour of the circumstances in which these changes might have an impact.

Ms Tierney—What may have been missed by Ron in that introduction is that this example and our submission are based on the possibility of the imposition of a maximum priority rule. Our submission is focused entirely on that proposal—

Senator WONG—And on the assumption that there would be no recovery against the directors personally.

Ms Tierney—Yes. We have not covered that issue in our submission. The examples that Jon is going to go through compare how they would lend currently as opposed to how they would lend if there were a maximum priority rule in place.

Mr Hardaker—Thank you for that; I stand corrected.

Ms Tierney—I just embellished it.

Mr Millin—Case study No.1 is of a client we have with a turnover of around about $120 million in sales and about 370 employees. It is in the transport industry, mainly in the business of bulk haul transport of commodities—things like grain, coal and those sorts of things. Historically, the performance of the company has been very mixed. Profit margins in recent years have been quite low. Over the past five years there have probably been a couple of years when the company has experienced significant negative profitability—it has lost money—but in the last couple of years it has been tracking okay. What you expect to see on the balance sheet

with this kind of company in the transport industry is mainly accounts receivable and plant and equipment in the form of things that you can use to transport freight, such as trucks.

The way that we, as an asset based lender, approach the amount of money that we can lend to a company is quite a mechanical process. We take a look at the balance sheet first and debt serviceability second—both of those have to stack up. We look at gross debtors on the balance sheet and determine how much we can lend against that category of asset. Our current policy, with the product that we have, is that we can lend up to 85 per cent against that asset. So we look at the gross debtors and deduct things that are ineligible, which are those things that we think would not be recoverable if the company were to become insolvent. Debts over 90 days are excluded. There is a very mechanical process of excluding things that we call ineligible before we get to a gross debtor base that we think stacks up and that we can lend against.

We do have a formula for calculating the amount that we can actually lend against that particular asset class. It depends very much on the performance of accounts receivable over a period of time. For example, if a company bills $100, does it collect 90c or does it collect 85c? Those are the things that drive these particular elements, and we finally calculate a borrowing base, which is the amount we can lend against that company. We then crosscheck it against financial performance to make sure that if a company borrows a certain amount it will be able to meet those debt servicing repayments.

Senator WONG—What is revolver availability then? Is that the total amount of accounts receivable that you then calculate what you will lend against?

Mr Millin—'Availability' is a term that refers to the maximum amount that we can lend against an asset class. So for eligible debtors, we have said that the gross debt is less the things we take out—

Senator WONG—Yes, I understood that part.

Mr Millin—So revolver availability refers to a line of credit against accounts receivable and/or inventory.

Senator WONG—So it is 80 per cent of the eligible debtors. That is how you have calculated that, is it?

Mr Millin—Yes.

Senator WONG—That is all I wanted to know.

Mr Millin—'Term loan availability' is the term we use where we are talking about fixed assets, like property and plant and equipment. Those two added together give a total facility availability, which is the maximum credit we can lend to a company based on that asset profile or borrowing base. Currently for these fixed assets—accounts receivable and plant and equipment—we would not deduct employee entitlements. I will now move to the next column and talk about what would happen if we had legal advice that said, 'Look, you will have a shortfall of $3.3 million.' Based on a priority of employee entitlements, we would deduct that.

Consequently, that would reduce the facility availability by, in this case study, an amount of about 20 per cent.

Senator WONG—How would you calculate it if the company had already made provision for noncontingent employee entitlements? Presumably you would not deduct it then. A contingent entitlement might be redundancy or severance pay entitlements, because obviously they are contingent upon a particular event occurring. Leave entitlements are not—one accrues them regardless of what happens. If the company had already made provision for them elsewhere, presumably you would reduce the total facility available by whatever amount they had provisioned for.

Mr Millin—Yes.

Mr Hardaker—Subject to checking the amount for which the provision was made.

Mr Millin—I guess this was just intended to be one practical example, one company in our portfolio. The second case study is very similar. I do not propose to go through it in detail, unless you think that would be useful. It is a company in different circumstances, a food manufacturer, which probably has a different profile of assets on the balance sheet, but again this one just had a revolving line of credit against debtors. We have not, in that case, lent against other assets on the balance sheet. So, again, having to reserve for employee entitlements would have an impact of about 22.7 per cent.

Senator WONG—In terms of calculating what you are prepared to lend, I presume that if there are other creditors of the company, you must put that into the mix—or do you not?

Mr Millin—Generally in our business, we are the sole financier. So it is generally the case that this particular business I work for is the sole provider of finance and we take out fixed and floating over the assets of the business.

Senator WONG—What would happen if you were not the sole financier?

Mr Millin—If there is another fixed-charge lender in there who has taken a particular asset, and we do not have access to that asset, we calculate our borrowing based on the assets we are looking at.

Senator WONG—So you would reduce what you would look at by virtue of that?

Mr Millin—We simply reduce what we look at. We are very selective. A balance sheet might have a number of different assets on the assets side. We look at the category of assets that we are comfortable with. There might be other categories of assets that other lenders have taken or that have value but which we will not lend against.

Senator WONG—So the amount of equity available to a company that you are financing is reduced if there is another secured creditor who has a charge over some aspect of the assets of the company?

Mr Millin—Certainly if those assets are not available to us.

Senator WONG—So that would reduce the amount of finance you would be prepared to give.

Mr Millin—Yes.

Senator WONG—Do you make any reduction for any unsecured creditors? I suppose if you are an asset lending company, you would be unlikely to do that.

Mr Millin—The short answer is no. We selectively look at the assets we are taking security over and, provided our advice is that we have priority on those assets, there is no need to take other people’s interests out of those assets.

Senator WONG—Mr Hardaker, I have read your submission on this issue. There are quite of number of things where I think we might just have to agree to disagree. Certainly the examples you provide confirm my suspicion that a maximum priority may have an impact on equity availability and cost of equity. The question I suppose for the government or the parliament is the balance between that and the reasonably desirable public policy objective that people receive their minimum legal entitlements and that the cost of business ought not to be financed through directors risking those minimum entitlements, because that is essentially what we are talking about. If people fail to make provision for it, it is the employees’ money which is being risked in the venture. To argue against giving some priority through whatever means of employee entitlements is to say that employees should do that, and I disagree with that. Do you want to respond to that?

Mr Hardaker—It is a very difficult policy question because we are moving from a position where effectively the employees are performing that role. If you change that, that changes the balance. Apart from recognising that it is a difficult policy decision, what we endeavoured to do in the submission—and, indeed, with the examples today—is to point to the consequences of that.

Senator WONG—Certainly in respect of asset based lending, it just seems logical to me that you are going to reduce it—aren’t you? You currently have priority, and if you do not have priority you are going to assume the worst-case scenario that you do not get it so you reduce the amount you lend. It just makes sense.

CHAIRMAN—Is it the case that in giving maximum priority to employees—and taking cognisance of what Senator Wong has said, and certainly not underestimating the issue that this involves employees who do lose their entitlements—you are in effect protecting a relatively small group: those who are employees of companies that are going to go broke, on the one hand, at the cost of virtually all businesses, whether or not they are going to go broke, on the other hand? In other words, are you saying that changing priorities will in fact cause a rationing of capital to all businesses?

Mr Hardaker—Yes.

CHAIRMAN—Even though it is only a small number, at the end of the day, that might actually be detrimentally affected in terms of having to meet employee entitlements in that situation?

Mr Hardaker—That is right. Unfortunately Jon cannot get a list of those companies before he does his calculus.

Senator WONG—You also made reference in your submission, Mr Hardaker, to the Corporate Responsibility and Employment Security Bill 2001. You dealt with the quarantining of assets—I think that is what you were referring to in that paragraph—that is, corporate structures whereby effectively the assets are quarantined from subsequent claims by employees. Is it really the position of your organisation that creative corporate structures, which clearly are developed in order to avoid paying out legal entitlements, should not be able to be pierced?

Mr Hardaker—I would think we would see that as a market phenomenon happening that the policy makers needed to be cognisant of. I do not have a view one way or the other. I would assume that if people are deliberately getting around something, they should be able to.

Senator WONG—You referred to it as the development of entrepreneurial business activities. I think there is a distinction between what might be covered by that phrase and corporate structures which clearly are put in place to try and minimise the possibility of successful action being taken against the company that holds the assets—that owns the assets for the payment of creditors, including employees. That is not an unusual corporate structure; it has certainly been the subject of litigation on previous occasions. I assume that you are not advocating that that should simply be allowed and that we should just accept that that is part of doing business.

Ms Tierney—Yes, you should be able to probe through or lift that corporate veil if it is the intention of that process to subvert or protect the organisation against claims. At the same time, that has to be balanced with the ability to structure your business so that you can develop and grow that business in the direction that you want and to be entrepreneurial.

Senator WONG—Does that mean making sure your employees are employed by an assetless company?

Mr Hardaker—I think that is getting around it. That is what Alison was talking about. If you are going forward into a more entrepreneurial segment of the market, you need to be aware of what the changes to your liability situation will be, but you cross over a point where you are trying to subvert the intent of the legislation.

Senator WONG—I have two more questions on the employee entitlement issue. I will get through those quickly so that Senator Chapman can get back to what he wants to ask about. The way in which an asset based financier will approach this issue is quite obvious to me. Are you able to give any view about how other lenders might approach the issue?

Mr Millin—I guess the broad category of lending we are talking about is senior secured lending. Sure, we are an asset based lender—we tend to look at the balance sheet first and then look at the cash flow second. You will hopefully have an opportunity to talk to cash flow lenders as well. My understanding of a senior secured cash flow loan is that you first look at the ability of the company to repay through cash flow amortisation over a period of time and the debt service coverage ratios, but if it is a senior secured loan you have to be comfortable at the end of the day that the assets support the full amount of the senior secured loan that the company has. Regarding the description of us as an asset based lender, I guess you should not draw the

conclusion that a cash flow lender approaches things differently in the sense that they do not look at assets on the balance sheet and they might do a check in terms of the amount that they are lending on a similar basis.

Senator WONG—So your view would be that it would be likely, but perhaps not quite as mathematically obvious, that the amount of equity a cash flow based lender would be willing to lend in the circumstances of a maximum priority being given to employee entitlements would also be reduced?

Mr Millin—Yes, I believe a cash flow lender looking at a cash flow loan will still look to the value of the assets to support the total amount of senior secured debt that they will lend. They will probably not approach the assets on the balance sheet in as mechanical and mathematical a fashion as we do. My view is that it would still have an impact on a cash flow lender's appetite for a certain level of debt.

Mr Hardaker—It would probably go to the pricing of that as well.

Mr Millin—Yes.

Senator WONG—I think we have the ABA next, so I will try and ask them. One of the options that has been suggested and discussed in the course of these hearings—either as an adjunct to or potentially, I suppose, as a replacement for the maximum priority proposal—is a proposal whereby directors in their annual reports are required to report on the provisioning for employee entitlements. I interpose by saying that you might want to look at the difference between a contingent liability and a fixed liability. If the company subsequently becomes insolvent, the directors can be personally liable if the statement that there was provisioning is incorrect or that a reasonable person ought not to have made it—some sort of objective test in that way. I wonder whether you have any comments on that. To me the intention would seem to be more about trying to encourage behaviour on the part of the directors, in terms of provisioning, rather than focus on what you do if the company goes bust. I think there are obvious issues, particularly in the small and medium enterprise area, for financing.

Mr Hardaker—The issue there, especially if you get a small business test—whatever small business test comes up, if it comes up in this package—is that the financial statements are going to need to give a degree of comfort, firstly as to the number of employees, if that is the criteria used, and secondly as to what sort of contingent or non-contingent liabilities are there that then get audited. Because one of the points we make in our submission is that once you get those sorts of tests you are effectively requiring one or more lenders to go in and verify that these provisions have been made and that they are still there. If in that calculus or indeed the cashflow lending calculus you verify yourself that there is an account somewhere with all this neatly tucked away in it, you need then to ensure that that continues.

Senator WONG—No, but if that proposal were put in place without the maximum priority proposal being put in place why would lenders then need to—

Mr Hardaker—Without it?

Senator WONG—Yes. Because the action then is against the director personally, if the duty is breached.

Ms Tierney—One of the things we point out in our submissions is that we believe that the maximum priority rule is not behaviour changing. It places the onus for our members on us—to monitor their behaviour and make sure they are behaving correctly. So we think that implicit in that is that if there is going to be some sort of reform in this area it should actually produce behaviour change, but in the right place within the organisation.

Senator WONG—So does that mean you think there is some merit in what I have outlined?

Ms Tierney—In making it a requirement to report that some provision has been made?

Senator WONG—Correct.

Ms Tierney—I think there is.

Mr Hardaker—It would certainly focus the director’s mind each annual report.

Senator WONG—Would you be able from your membership to provide us with any information about how a cash flow based lender might approach the financing equation in—

Mr Hardaker—We could certainly come back with that.

Mr Millin—We do cash lending as well, but we are principally an asset based lender. So I can talk about the way that we would do a cash flow loan. The way we would do it would be to focus more on the cash flow statement and the profile of paying down the debt. I guess it depends on the confidence that we have that the cash flows are sustainable. Ultimately, if you are determining the capital structure of a company, if a company with an enterprise value of $500 million has $200 million of senior secured debt, you have to be confident that the senior secured debt is supported by assets on the balance sheet.

Senator WONG—So, if the maximum priority were implemented, you would add that to the senior secured debt and look at that as against the asset base and use it to calculate how much you would lend?

Mr Millin—You would have to deduct the employee entitlements.

Senator WONG—Thank you.

CHAIRMAN—In the context of this issue, would another likely response—although you said it is not going to be behaviour, so it is changing—be to increase the amount of outsourcing that companies do, including using contract labour and that sort of thing?

Mr Hardaker—One of the other behavioural changes we alluded to was that companies might change their structure and do that outsourcing—or have the service company—rather than have the assets in the same one as the service company. If businesses are out there looking to

adjust to whatever regime emerges, they would be looking to make their position better than it might otherwise be.

CHAIRMAN—So you think that is a real prospect?

Mr Hardaker—It is a risk, yes.

CHAIRMAN—I do not think I have any more questions on the employee entitlements issue, so thank you very much for your contributions.

Mr Hardaker—As I mentioned earlier, this segment of our two submissions is dealing with those in relation to chattel securities rather than the senior debt that was covered earlier. The main proposal we have put seeks to remove the current duplication in the registration of security interests. Currently, in relation to motor vehicles, there is a requirement to register on REVS, which is variously described as VSR or REVS in the different state jurisdictions, and to protect your position also under the Corporations Law. We see that as an expensive duplication and it is only partial. In the same way as particular sections of the Corporations Law exclude from some state jurisdiction land, bills of sale registration, boats, liens and what have you, we would see a reverse situation happening in this area, given that the state registers of encumbered vehicles are very widely available. I think within a month of WA coming in, all the mainland ones are instantaneously linked. They are certainly much less expensive and would offer a one-stop title checking service. We would encourage the committee to have a look at that proposal and we would be happy to provide any other information required.

CHAIRMAN—Does this come under the corporate insolvency current law or is it under state law?

Mr Hardaker—It is under the Corporations Law.

CHAIRMAN—It does not come under state law?

Mr Hardaker—No. The encumbrance registers come under state laws, which is one level of reporting and disclosing, then you have the second level under the Corporations Law.

CHAIRMAN—Has this issue purely arisen as a result of the changed financing arrangements that people have entered into because of the GST or is it a broader issue?

Mr Hardaker—That has compounded it, but it is an issue that we would have raised in any event given that, whether it is a small percentage or large percentage issue, there are major efficiencies to be had there. I think the ratio of 120 to 10 sticks in the mind in terms of cost, paying ASIC or the state vehicle registers.

CHAIRMAN—Is it purely your sector that is affected by this or is it universal?

Mr Hardaker—It would be all motor vehicle financiers, most of which are our members.

CHAIRMAN—So they come under your bailiwick.

Mr Hardaker—Those fees are passed on to the customer, so it is really all the customers.

CHAIRMAN—So that would then lead to a cost saving—

Mr Hardaker—a significant cost saving.

CHAIRMAN—for the people who are leasing?

Mr Hardaker—Yes, for those who are leasing, hiring or borrowing generally. Let me just step that back a level. It would lead to a cost reduction for those who are chattel mortgaging as distinct from leasing or hire purchasing.

CHAIRMAN—That certainly clarifies the issue for me.

Ms Tierney—Ron mentioned the fees there. From September, I think they have gone up to $135 per registration of charge. Every time there has to be a discharge of that charge another $65 is paid. One of the concerns is that perhaps those charges are not going to be taken off the register and will just clog up the registry of charges, because it will be up to the customer. The release form will be provided to them on finalisation of the transaction but the customer may not lodge that. So some of those charges may stay there for longer periods than necessary.

CHAIRMAN—Is your proposition that this apply only to motor vehicles or is a broader?

Mr Hardaker—Given that the REVS only applies to motor vehicles—and, in some states, to boats—it would apply only to those classes of assets.

CHAIRMAN—You also say that your members have encountered difficulties in locating equipment that is no longer required by the administrator. Your proposal would require the administrator to state the location of equipment to the lessors or financiers. Can you enlarge on the sorts of activities you have experienced in that regard?

Mr Hardaker—Those are I suppose the two 'micro-issues' in our submission. I think the administrator will tell you that he no longer wants to use something, but where that particular item now is—within what could be a national company—is not necessarily advised. Given that the administrator, having come to the view that he no longer needs it, would know where it was, we think that that would be a change which is not onerous but which would be very helpful to the advice mechanism. The other micro-change to administrators is the fact that, if the administrator uses the item for a little while before deciding he no longer needs it—if revenue is earned with it—there could be a little bit made in the way of interest paid for that use over that period. As I say, these are two of the micro-issues that came out.

CHAIRMAN—Is that issue peculiar to voluntary administration or does it relate to winding up as well?

Mr Hardaker—I am not sure.

Ms Tierney—We have mainly encountered it in the voluntary administration area.

Mr Hardaker—The other issue is that of controllership, which, again, is a micro-chattel issue. Under certain of the definitions, to take possession of an item of machinery or a car, puts you into a controller definition that requires the opening of bank accounts and reporting and what have you. Some years ago, we sought and gained administrative relief from the bank account opening provisions and we are just seeking to see that carry over into any amendments of the law that may eventually flow through—plus the reporting requirements that flow with it.

Senator WONG—So you are essentially seeking registration of title in respect of motor vehicles? Do you think that any negative consequences would flow from the issue you have just raised? For example, in the event of liquidation, would it render it more difficult for the liquidator to locate assets that should properly be the subject of calculation in the liquidation process?

Mr Hardaker—Is this the encumbrance register issue?

Senator WONG—Yes.

Mr Hardaker—I would not think so. The register can be searched nationally, as would be done through ASIC. The item being at an address different from the one on the particular record is just as likely under ASIC as it is under the REVs. In any event, as part of his due process, the administrator would do a stocktake of what they had and would query things that are there as securities over which he cannot find the asset, I think. So I cannot see any negatives there. A couple of years back, Professor Duggan raised a range of particular legal issues—amongst other things, going to the perfecting of security—within the broader national network of registers operated by the states. A review of where the particular register should be would be a good catalyst to having all those things properly considered and built into the new system.

Ms Tierney—I would go so far as to say that there would be a positive benefit in terms of having those motor vehicles registered on REVs. That is a register of the vehicle and its details. In terms of identification, that makes it much easier to track the vehicle, whereas the corporations register only allows registration against the company name. REVs provides a mechanism for tracing the movements of those vehicles should they disappear in some way.

Mr Hardaker—As I recall, the asset registration does not include major identifiers for the vehicle; it is more generic descriptors.

Senator WONG—With this issue of controllers, you refer to PS06, which you say has alleviated some of your concerns. It is not clear from your submission whether you are asking for additional relief from the obligations or whether you are saying we can take into account what has been done in PS106 with any further changes that might be proposed.

Mr Hardaker—We are currently taking advantage of that relief. It was given by that mechanism because the law was not about to be amended in the foreseeable future. Should something come out of this inquiry that sees it being amended, we would see that as an opportunity to capture that.

CHAIRMAN—As there are no further questions, I thank both of you for your appearance before the committee and your contribution to our deliberations.

[3.29 p.m.]

GILBERT, Mr Ian Bruce, Director, Australian Bankers Association

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy, Australian Bankers Association

LEONARD, Mr Michael, Executive General Manager, Group Risk Management, Commonwealth Bank of Australia

CHAIRMAN—Welcome. Do you have any comments to make about the capacity in which you appear before the committee today?

Mr Leonard—I am providing technical expertise to the Australian Bankers Association.

CHAIRMAN—The committee prefers all evidence be given in public, but if at any stage of your evidence or response to questions you wish to respond in private you may request that of the committee and the committee would consider such a request to move to in camera. The committee has before it two written submissions from the ABA—28 and 28A, as we have numbered them. Are there any alterations or additions you wish to make to the written submissions at this stage?

Mr Hossack—No.

CHAIRMAN—I now invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Mr Hossack—I would like to make a few additional comments on the ABA's submission regarding employee entitlements and specifically the proposal to elevate certain employee entitlements above secured lenders for fixed charges against assets. This is known as the 'maximum priority rule'. In our submission to the inquiry we sympathise with the plight of workers who lose their job without adequate entitlement protection. However, we argue that these employees will not be advantaged by the maximum priority rule as their entitlements are already safeguarded by the government's safety net scheme, GEERS. We also argue that the unintended consequences of the maximum priority rule will be to create uncertainty and increased lending risk to businesses that have employees by eroding collateral value. Banks may respond to the uncertainty in collateral recovery values by managing that new risk using their established tools—these include reducing those loan limits and increasing the price of loans.

The more the industry has looked at this issue, the more we believe the maximum priority rule will impact on lending limits more than interest rates, although individual banks will ultimately decide how to manage these new risks consistent with prudential requirements. These impacts will have wider consequences in the community, including a negative effect on economic activity. The ABA believes the banking system is the wrong mechanism to address the entitlement loss problem. It will create a new uncertainty over the business collateral that will need to be prudently managed. The ABA supports the GEERS because it has the advantage of

being a post-event funded scheme whereby money is only spent when entitlements are lost. With a maximum priority rule, businesses will pay for the uncertainty it creates on loan collateral whether these businesses fail or not.

Mr Gilbert—Perhaps I can make a couple of opening points for the benefit of the chair and members of the committee. Mr Hossack is handling the MPR side of things and I am picking up the rest in relation to voluntary administration and the second submission that the ABA lodged with this committee. I will just mention a couple of opening points, and I will be very brief.

The general consensus is that the voluntary administration regime is working well according to available evidence. A 1998 CASAC—now CAMAC—review of the regime found it generally successful and popular. If this committee were minded to substantively alter Australia's administrative regime for managing companies in insolvency, I would draw to the committee's attention a serious lack of proper data that would assist in proper policy formulation. If that data is not available, the ABA would submit that it would be unsafe for changes to be made to the regime in the absence of that data. In the submission, we have made some suggestions for finetuning the voluntary administration regime to make it a little bit more flexible. I think that is the keynote to going forward.

CHAIRMAN—With regard to the issue of employee entitlements, the maximum priority proposal in effect only extends the existing priority that employees have over the floating charge element of secured assets to fix securities. Is that really going to have a substantial detrimental effect, as you argue, in terms of either the rationing of finance or the interest charge for finance?

Mr Hossack—We have discussed this issue extensively with our banks and the feedback that we have got from them is that this is certainly going to be a very fundamental change in the way they go about financing loans to many businesses, particularly small and medium sized businesses, because those businesses rely upon the value of the collateral that they bring to that negotiation to secure the loan. If a new uncertainty is created over that collateral, then the bank will have to have a real hard look at it to make sure they understand the risk that is associated with that uncertainty and therefore, consistent with prudential requirements, manage that risk responsibly. So, yes, we do think it will have a significant effect.

Senator WONG—Has the fact that employee entitlements have already had priority over floating charges led to a similar effect in terms of the limit on financing and/or the cost of financing?

Mr Hossack—We have not got any data which indicates that. I am not aware of any study in the Australian context which has looked at that.

Senator WONG—So why the extension of it to have priority over secured creditors? Why does doing that with fixed charges have the consequence that you state?

Mr Hossack—Because traditionally when banks have lent to the small and medium sized business sector they have relied heavily on the value of the collateral. What this does for the first time is really bring an uncertainty to that collateral which is posted for security—we have not seen that before—whereas the floating charge is over the business, which is the debtors and so on, but not over the fixed asset.

Senator WONG—So it may or may not have had an effect in terms of lending against floating charges, but you are not aware of that.

Mr Hossack—That is correct.

Senator WONG—You make the point about GEERS. Obviously the issue with GEERS is that it does not protect people's full entitlements. I assume you would understand that.

Mr Hossack—I understand GEERS.

Senator WONG—It is capped?

Mr Hossack—I understand it is capped at $75,000.

Senator WONG—And it is capped in terms of the number of weeks of redundancy pay available, so there are often significantly greater redundancy entitlements at law than GEERS pays. We have recently had some evidence—and I think you were in the room, Mr Gilbert, for this—from the Australian Finance Conference and some evidence from a finance company which is primarily an asset based lender. They said quite clearly, 'The way that we would approach it in terms of how we approach these calculations is that we would reduce, by the totality of the employee entitlements, the value of the asset base against which we would lend, thereby reducing the amount of finance available.' I assume the information that you have referred to in the letter that you have provided to Treasury has a similar analysis.

Mr Hossack—Yes, that is correct. The information that we put to Treasury was really trying, in the absence of the detail that we needed to do a full-blown implication study, to highlight to them the implications of this.

Senator WONG—Are you able to provide us with that in camera?

Mr Hossack—We suggested in our submission to you that if the committee was interested in that we would go back to the banks that provided that data and we would certainly endeavour to show you, with proper confidentiality arrangements, that information.

Senator WONG—We would be interested in it. Would you please take that on notice and perhaps have some discussions with your members about that?

Mr Hossack—We will certainly do that.

Senator WONG—One of the options that have been put up, either as an alternative or as an adjunct to a maximum priority rule, is trying to put in place behaviour changing regulation, rather than simply doing something when a company is liquidated.

One of the proposals that is being discussed is to require of directors that they actually make a statement in the annual report of a company regarding the provisioning that has been made for employee entitlements and an assertion as to their belief that such provisioning is reasonable and that employees would then have a right of action against the directors personally if that

statement were incorrect. I suppose one would put a test in there that it was unreasonable in the circumstances; that a reasonable person would not have made that assertion.

If that were in place, it would look to two things: first, it is trying to alter behaviour of directors so that the company operated on the basis that adequate provision must be made; second, any action taken to recover would be against the directors rather than dealt with through the liquidation process. Do you have any comments to make in relation to that?

Mr Hossack—We have not looked at that proposal or done any work on the implications of that, but that is something that we would be happy to do.

Mr Leonard—I would like to make a separate comment with regard to our submission, not in regard to our view of the statement by directors and the accounts. In our submission we were looking at the potential impact it would have on the losses we may incur and therefore on the amount we may make available. I would not see purely a statement in the accounts actually addressing those particular issues. All it would necessarily do is quantify the amount, as against change the prospective loss—or reduction in recovery—that we may incur.

Senator WONG—Surely, your attitude to that would be altered if this were put in place as an alternative to the maximum priority rule?

Mr Leonard—I took your question as being that it was supplemental, not as an alternative. I put ‘in addition to’, as against ‘an alternative’.

Senator WONG—But if it were an alternative though, I would assume that your members’ position would essentially not be altered. If such a proposal were implemented without a maximum priority rule, your members’ position would not have been altered.

Mr Hossack—The position that we have taken is that we oppose the maximum priority rule because we think it fundamentally disturbs the important relationship. We have not looked at this proposal or, indeed, the implications of it. Without doing that, I would not feel as though I was in a position to comment.

Senator WONG—Perhaps you could come back to us on that. Did you say you oppose the MPR because it fundamentally disturbed the employment relationship?

Mr Hossack—No, the lending relationship.

Senator WONG—I assume that this data to Treasury attempts to quantify what effect it would have.

Mr Hossack—Correct.

Senator WONG—I have nothing further on that. You did make one comment in the opening—either Mr Gilbert or Mr Hossack—that the likely consequence of an MPR was generally to reduce loan limits rather than increase cost of finance. Is that correct?

Mr Hossack—Yes, we have had a lot of discussion about this. Early on, when the policy was announced, the feeling was that this would mainly be an effect on price, as in the banks would accept the risk and increase the premium. However, the more we have looked at it—and I think the more the banks have—the weight of opinion is tending towards that it is probably going to have more of an effect on the loan limit rather than the premium.

Mr Leonard—As to the initial decision that a lender would make as to how much it would lend, the maximum priority rule impacts upon that particular position. That would be the initial decision. Therefore, rather than getting to the pricing stage, the first decision is how much money we would make available against certain security.

Senator WONG—That makes sense because essentially what it does is reduce the value of the asset against what you can lend.

Mr Leonard—Correct; which gets back to your earlier question about what the difference is if there is already a priority for employee entitlements against a fixed and floating charge versus a fixed charge. It really changes and undermines the whole value of your security, which generally is the basis that we lend in the small to medium enterprise market.

Senator WONG—But surely the fact that employee entitlements have a preference over floating charges may also have an effect. Did your members or did you take that into account when lending on the basis of a floating charge over the entirety of the company's business?

Mr Leonard—We take that into account when lending against floating charges now. Therefore, in a lot of cases we attribute not much value to a floating charge, having regard to priorities and other issues with floating charges.

Senator WONG—I see. So you deduct it, essentially. From your members' perspectives or experiences in the small and medium enterprise sector, is most of the equity lent from your members against fixed charges?

Mr Leonard—Could I say that it would be to loan money rather than to invest money.

Senator WONG—Sorry; is most of the lending that you do—

Mr Leonard—Yes, the lending in the small to medium enterprise market is generally on a secured basis.

Senator WONG—What sort of percentage are we talking about?

Mr Leonard—I expect it would be quite high.

Senator WONG—Over half or over 90 per cent?

Mr Leonard—I would expect a little over half—I could not quantify whether it is 90 per cent or not.

Senator WONG—Do you have that data available?

Mr Leonard—I cannot speak for the rest of industry—

Mr Hossack—We can certainly endeavour to get that for you.

Senator WONG—Could you do that, because we have had a lot of evidence on this from both sides and people feel very strongly about this issue. On the other side there is one potential consequence—which the parliament may decide is something they are prepared to accept or they may not—and I think the sort of scale of the potential impact would be of interest to us. You may be able to provide us with some sort of demographic, in the small and medium enterprise sector particularly, of what proportion of the loans would be secured loans.

Mr Leonard—Yes, we will do that through the ABA.

Senator WONG—Thank you. I appreciate that.

CHAIRMAN—In your submission, you are negative about suggestions that Australia move to a chapter 11 type bankruptcy procedure as against the existing voluntary administration procedure. One of the criticisms that have been made of the voluntary administration procedure is that it does not provide the incentive for sufficiently early intervention in a company to allow a successful turnaround of the company and it almost inevitably results in the company going bankrupt rather than being revitalised. Is that not one of the advantages of chapter 11? If so, how? If not going to chapter 11 procedures, do you have any proposals to perhaps change our voluntary administration procedures to encourage that earlier intervention?

Mr Gilbert—I suppose there are three strong incentives already embedded in the law to encourage directors to take the step of putting a company into voluntary administration: firstly, personal interest—a voluntary administration stays actions against directors under personal guarantees; secondly, the reckless trading provisions—the insolvent trading provisions—where they can be hit with a personal liability; thirdly, because the tax office is invariably a creditor in these situations, the legislation for group tax permits the ATO to serve a notice on the company to pay the amount or go into liquidation within 14 days and, if they do not, then the directors are personally liable. So there are three very strong incentives in the legislation. That is not to say that a fourth and more powerful incentive could not be a requirement for directors: where a company is insolvent or is likely to become insolvent under the test that is currently in the voluntary administration regime, they would be required to take the step of appointing a voluntary administrator. At the moment that legislation does not contain that requirement.

Mr Leonard—I could add to that. I think the question is based on the assumption that a chapter 11 procedure occurs earlier than voluntary administration. My perceptions, particularly in recent actions in the US, would not necessarily support that assumption.

CHAIRMAN—Are you aware of the UK corporate voluntary administration procedures?

Mr Gilbert—There are two forms. There is one that was legislated some time ago, which is a corporate voluntary agreement. A more recent enactment is the Enterprise Act, a voluntary administration regime which is not very different—except in one respect—from what we have in this country. The situation in the UK is difficult to compare with that in Australia. In 1993 Australia took the plunge and introduced our voluntary administration regime. I am helped by an

article written by Professor Andrew Keay that was in the *Insolvency Law Journal* in 2003—I can give you the correct citation later on—in which he says that, unlike banks and other financiers in the UK, those in Australia got behind the voluntary administration regime. What he is really saying is that Australia put in place this regime a decade ago, where England had not done something similar, and the way in which that has been managed going forward in Australia shows a relatively high incidence of voluntary administrations versus chargee-initiated receiverships. There is strong evidence of that anecdotally; it would be helpful to have proper data, which does not exist. We would be confident in saying that voluntary administration had headed off a number of what would otherwise have been companies winding up.

Senator WONG—Mr Gilbert, you commented on the possibility of amending the law to put in place a requirement that, if the company were or were likely to be insolvent, directors place the company into voluntary administration. Is that something that you are proposing?

Mr Gilbert—I could make that a formal proposal, subject to consultation with members. I am happy to take that on notice and come back quickly to the committee on that.

Senator WONG—Are you able to indicate what negative consequences might flow from that? I suspect company directors might have a view about that.

Mr Gilbert—That if the company is insolvent—

Senator WONG—To place a duty on directors to put the company into administration in those circumstances.

Mr Gilbert—I think there are strong incentives in the act that lead one to that point anyway in terms of what the responsibilities of directors are. If you look at sections 181 through 184 of the Corporations Act, there is a requirement to manage the affairs of the company competently, honestly and in good faith. So I think you can probably say it is already there, but perhaps as a pointer. It could be more explicit.

Senator WONG—Do you see any negative consequences of your mooted change?

Mr Gilbert—Not immediately. I suppose it prefers one administration over another, and that may be a question—

Senator WONG—That administration being by an administrator as opposed to the directors?

Mr Gilbert—Yes. It might be that the company approaches its secured creditor and says, ‘Appoint a receiver.’ So perhaps one needs to think about not confining it to one particular option that may be appropriate.

Senator WONG—So you will get back to us on that matter?

Mr Gilbert—I will definitely get back to you with an answer on that, yes.

CHAIRMAN—In relation to phoenix companies you suggest that there should be a register of directors who receive five-year bans readily available to businesses. Is that a correct interpretation?

Mr Gilbert—Yes.

CHAIRMAN—I am ignorant here, in a sense. That information is not readily available from ASIC at the moment—who is subject to a ban?

Mr Gilbert—It is not clear to us that it is, and I think the more information that the business community has about those who do not adhere to sound corporate governance principles, the better for the community.

CHAIRMAN—Apart from that register making you aware of those who have been banned, do you believe the current legislation is strong enough on dealing with phoenix companies? Notwithstanding the capacity to ban directors at the moment, it seems that the phoenix company problem persists.

Mr Gilbert—Yes, it does. I suppose it is one thing to legislate proper standards of corporate governance but it is very difficult to legislate against what I describe as a lack of integrity and poor ethics. It is very hard to develop laws around that. There will always be people who want to beat the system but I believe there are, within the laws, sufficient powers at the moment for regulators to take action in regard to these people.

CHAIRMAN—In your submission, in relation to deeds of company arrangement, is the only issue you are raising the time frame for the relevant meeting or are you suggesting there should be a standard deed of company arrangement rather than a deed of company arrangement arrived at in the context of a particular enterprise?

Mr Gilbert—Yes. I suppose it would be very helpful, particularly to creditors, if there were standard terms applicable to these deeds of company arrangement which would apply in virtually all cases. So you could develop a standard document with a flexible part to record the actual agreement and the specific terms under which the agreement has been negotiated. But there should also be, I suppose, a set of standard terms and conditions that would apply in these deeds.

CHAIRMAN—I am not sure whether you have addressed this in your submission, but what is your view on the timing of meetings? Do you think the time frame is too short between the first and second meetings?

Senator WONG—I think you want 15 days, don't you?

Mr Gilbert—Yes, for the decision period.

CHAIRMAN—I thought I saw something about that, but I could not quite put my finger on it.

Mr Gilbert—I think it should be seven days for the first meeting of creditors and 35 days for the convening of the second meeting. It is important in relation to the first meeting that there is sufficient flexibility, particularly for the court, to allow appropriate time frames—again, as an aid to flexibility and the ability of the VA to adapt not only to small administrations but also to large administrations.

CHAIRMAN—Another issue that has been raised through our inquiry is either the perception or the reality—and I will ask you which of those you think it might be—of a lack of independence on the part of administrators. I suppose that a related issue is the cost of administrators' and liquidators' fees. Does the ABA have a view on those issues?

Mr Gilbert—I would not like to comment on the fees of administrators. I think there are others who are far more qualified to do that than me. Could you repeat the first question?

CHAIRMAN—It was about the perceived or real lack of independence.

Mr Gilbert—We have a strong view on the fact that the administrators must be independent. The integrity of their administration depends on that. Whatever measures may be able to be taken by the bodies that represent administrators themselves, to ensure that that happens, would be a very good thing.

CHAIRMAN—Do you think any changes need to be made in terms of the legislation? One suggestion that has been put to us is that some sort of roster system might be introduced to determine who becomes the administrator.

Mr Gilbert—We certainly support some standards being set for administrators, which would include principles surrounding independence. Perhaps the regulator, ASIC, could be well-positioned to do that. In fact, it is ideally positioned to do that. One should not forget that an administrator is effectively an officer of the company and basically has directors' duties, just like directors have. So there are still strong provisions in the legislation that would direct an administrator's mind to potential conflicts and compromises of independence.

Senator WONG—I want to follow up on Senator Chapman's point because I think it is an important one that has been raised a number of times. There have been a number of proposals aimed at trying to improve the perceived or actual independence of administrators. These include a roster system, and there have been criticisms of that, in terms of expertise, efficiency and so forth. A second suggestion is that a code of ethics be included in the legislation. A third suggestion is that a statement of independence be provided to creditors prior to the first meeting. Do you have any comments in relation to any of these?

Mr Gilbert—We have not considered those in any great detail. We see the industry of administrators sorting out how that problem is best dealt with. Whether it be self-regulation or whether it be a mixture of regulation plus self-regulation, they are perhaps better qualified to judge. But the principle that they should be, and should appear to be, independent is one that our members feel strongly about.

Senator WONG—I am sure they do.

Mr Leonard—Chairman, your point re the expertise and skills of administrators is critical from our point of view, because they basically become the management of the company. Therefore, we do not necessarily agree that a roster system is a means to achieve that when there are very clearly standards in place for receivers and liquidators et cetera. But when administration was implemented, the same standards were not necessarily upheld. We would make that as a comment. In the ABA submission, under the discussion of deed of company arrangement, we propose that standards be put in place so that creditors could monitor the performance of the company against the specific criteria that were set initially. Again, we hold to that view.

Senator WONG—Where did you make that submission? Was that when the voluntary administration scheme was first implemented?

Mr Leonard—I am talking about page 15 of the Australian Bankers Association submission, under the heading of ‘Compliance with and effectiveness of deeds of company arrangement’. You will see it in the penultimate paragraph of that page, where it talks about standards or indicators.

Senator WONG—You might want to consider that question, Mr Gilbert. You seem to be saying that you prefer the administrators themselves to put their views on this to us. But if you did have any views on this issue of independence we would like to hear them. I have to say I agree with you, Mr Leonard; a roster system seems to me to have as many flaws as strengths. I am not particularly of a mind to agree with it, but some of the other issues perhaps deserve some consideration.

Mr Gilbert—I will come back to you on those.

CHAIRMAN—I thank each of you for your appearance before the committee and for your contribution to our deliberation. It has been most useful.

[4.04 p.m.]

BASTIAN, Mr Paul, State Secretary, Australian Manufacturing Workers Union New South Wales

CHAIRMAN—Welcome. The committee prefers that all evidence be given in public, but if at any stage of your evidence or response to questions you wish to respond in private you may request that of the committee and the committee will consider such a request to move in camera. The committee has before it a written submission from the Australian Manufacturing Workers Union, which it has numbered 45. Are there any alterations or additions you want to make to the written submission at this stage?

Mr Bastian—No.

CHAIRMAN—I invite you to make an opening statement, at the conclusion of which I am sure we will have some questions.

Mr Bastian—I thank the committee for the opportunity to actually put forward some of our concerns about the state of the Corporations Law with regard to entitlements. To say the least, we think the current laws are inadequate to deal with the problem of workers' entitlements. I will go through some of our experiences and some of the examples that we come across. When we deal with the collapse of a company the first thing that we do is look to see whether or not the entitlements can be met by going though the assets and having a look at what assets are available to pay. Inevitably, we find that there are three areas in terms of where assets will fall. One is where the company has had a deliberate structure where assets are secreted somewhere away from the entity where the contract of employment is invested—in another company. There are examples in law where those arrangements are regarded as a sham you can get around by lifting the veil of incorporation. They are exceedingly rare. We had an example recently where a company called Metroshelf transferred 75 employees just prior to going into administration as a company that had no assets. As a result of that, the administrator voided that transaction.

The more common one is where the corporation is deliberately structured so that assets are separate from employees and the company. Again, Metroshelf is a clear example of that. There were 288 employees that were in about five companies, only one of which had any assets with which to meet any form of entitlements owed. In that area we also have the example of Genoa Plastics, which have actually said to our members at administrators meetings and to the administrator that they deliberately set their companies up in that format so as to avoid assets being held in the same companies in which the employees are held. Those structures are legitimate in law; they are known as asset protection. That is an area of concern for us but that is an area which involves being able to chase the assets and the money trail through related entity companies.

The other area is where the company has assets but there is a mortgage to a bank over the fixed and floating charges. As we know, a bank will have first priority over those, and there is usually nothing left in the pot to go to employees. The third category is where there are no assets at all left for anyone to claim, let alone creditors, in terms of employees getting any money. That

can also be contrived. We have had an incident with a company known as Plastyne, which was in the automatic components sector. It had a British parent company and it was up for sale. We were informed by some of the management during the collapse that one of the problems with the sale was that the company was highly geared in relation to the redundancy package that the union had negotiated in the enterprise agreement—in other words, it was unattractive because if they needed to sever parts of the company the redundancy payout would be too much; it was too highly geared.

That the sale was not going ahead too well was conveyed to our members. Shortly after that, the company was sold to a family trust—a husband and wife company. The structure of that sale was that the prime asset, which was the land, was held in a family trust. Six months later the company went broke and there was no need to worry about the highly geared component of it because they did not have to pay redundancies—they had no assets left. The remaining asset that could have covered entitlements went off with the family trust of the purchasers of the company. We say that that was a means of structuring the company to avoid their entitlements.

The second thing we get to do is look at the creditor's report. Over the last 12 months with every collapse we have been involved in, without exception, if you go through a creditor's report there will invariably be the administrator saying that there has been illegal or improper activity in, for example, insolvent trading. ASIC have advised us in relation to insolvent trading that a company is only liable for the period in which it traded as insolvent. Another example of improper activity is where there has been uncommercial transaction or undue preferences. In relation to the last two examples, ASIC also say that they are not really concerned with those two. They say that if there has been improper activity it is a matter for creditors to pursue in any winding up of the company.

We know that there will also be a confidential report on the act from the administrator to ASIC later on which goes into more detail about any improper conduct, but we are not privy to that because of the need for confidentiality between the administrator and ASIC—nor are we seeking to be privy to that; we only highlight that we are not given all the information about improper conduct. In any instance where we have found insolvent trading or any other improper conduct, we write to ASIC and ask whether or not there will be an investigation into the circumstances surrounding the collapse. On at least two occasions, ASIC have written back to us and said no, there were not sufficient resources for them to chase directors in all cases of companies going into administration and that they had to target their funds selectively to try to set precedents in the prosecution of directors. Indeed, we had one senior administrator tell us that if he were to go through his records his estimate would be that, on 98 per cent of cases where he has referred to improper or illegal activity, there has been no further action by ASIC whatsoever.

For us the issue is that there is no real deterrent in the legislation, which gives rise to phoenix companies. Again, Electruck is an example of a company that disappeared and then resurfaced under another name; a similar business, with the same directors, carried on. Related companies are an issue for us. They actually promote a structure where you have your assets stowed somewhere else because the law is very difficult to get around—the veil of incorporation. If it is being done legitimately, it is legitimate and you cannot go through the separate legal entity. Once you have found out that there are no assets or limited assets available, you get to the inevitable proposition of a deed of company arrangement. Again, this will be in circumstances where we

know there has been some conduct alluded to by the administrator, such as improper actions on the part of the directors.

The deed of company arrangement usually offers 20c in the dollar or 80c in the dollar—something less than 100 per cent. It also means that the directors are free from any further prosecution. So employees are left with a choice. If they have sufficient anger—and they always do—that they want to go after the directors and hold them liable for their actions, the administrator will quite correctly point out, 'If you want that, you must fund it from what's left in the kitty.' So you are in a position where you are throwing good money after bad. The other choice they face is, 'Do I take 20c in the dollar or risk losing the lot?' That is no real choice for a worker on $500 a week who is seeking to maintain their mortgage and get a job quickly. There is no real choice in that for them. It is simply: get what you can and move on.

There is also a contest that sometimes arises between the creditors—non-employees—and the employees because their interests and their resources are different. Employees have no resources to pursue directors; it has to come out of the funding. Some large creditors simply pursue the company because it is in their interests, due to the amount of money they are owed, and they do not necessarily care where that money comes from. If that happens to absorb the balance of what is left for employees, so be it. And there are plenty of cases where that contest between employees' interests and the interests of other creditors has been evident.

We think there is no real deterrent in the legislation. The problem as we see it is that ASIC are the enforcer of the laws, yet they are not given sufficient teeth to actually go after companies and enforce those laws. It is self-evident to us—and they have made it plain to us—that there are insufficient funds for them to carry out that litigation. So we see that there is a need to increase funding to ASIC so they can act as a real deterrent in these instances. We think one simple way to resolve it would be to place a reverse onus on directors. That reverse onus would provide, in the legislation, that in the event of going into administration, whether voluntary, a creditor's wind-up or court enforced, a director is deemed to have acted improperly until the director can demonstrate their bona fides to ASIC or some other appropriate body, showing that they have discharged their duties in accordance with the law. That would immediately solve the problem that we have of directors creating a situation, collapsing a company, getting rid of their dead wood and then resurfacing somewhere else to do the business—and it would solve the problem of ASIC being underresourced.

There is an area in law that needs to be addressed: related entity liability. Again I use the example of Metroshelf. Quite legitimately under the law they set up an elaborate corporate structure of family trusts and different entities, and the assets were well and truly secreted from the company that was severed and left to wither on the vine. Again, there was asset protection—perfectly legal—but we are totally unable, because of the way the law currently stands, to follow that money trail and hold those related entities liable for that loss of entitlements.

The other issue is to take the money away from employers and to put it into trust funds, which is part of our current campaign for the establishment of an industry fund which we call NEST. We would have employers pay into the industry fund monthly contributions for those entitlements. That would resolve the problem for us industrially once and for all. For us, NEST is not necessarily the answer. You cannot have NEST without law reform, because you could end up in the same situation with NEST if the employer does not make payments into NEST and

ends up in liquidation. For us it is a package of law reform and industry objectives in terms of what we are seeking to do with NEST.

CHAIRMAN—Given the public nature of the hearing—this might be relevant to some of our questions—we certainly appreciate having concrete examples given to us but it might be advisable not to mention the names of the companies.

Mr Bastian—I am sorry; I was advised that persons were the issue, not the names of companies. I am happy to comply with whatever is required. I will call them company A and company B.

CHAIRMAN—The major issue that has been put to us that contradicts your arguments in relation to giving greater security to employee entitlements—we had them reiterated this afternoon by the Bankers Association and the Finance Conference—is the impact that that would have on both the availability and the cost of capital. I wonder what your reaction is to the claim that it would cause financiers to ration capital. They would take into account the additional impost on a company through the employee entitlements and therefore not provide as much capital, and they would regard the company as having fewer assets against which their capital was secured. Also, the likelihood is that they will charge a higher rate of interest. Both cases are obviously detrimental to the ongoing activity of the business and its capacity as an employer.

Mr Bastian—If we are talking about ranking employees' entitlements above banks, I think there is a problem because of the very reasons you have outlined. There would be a greater cost to industry if they were to rank above banks. I am pretty sure that the banks would have a strong view about where they see their preferences and their lending capacity. Even if you did that, and they did rank higher than banks, there would be no guarantee. If a company collapses and it has 50 per cent left that it can pay, we only get 50c in the dollar. There is no guarantee that we will get our entitlements. That is not a fix per se; for us that is just another attempt to bandaid the problem. The problem is deeper than simply that. For us it is about workers who are on low wages and who inevitably lose all this money. They have to have some real security in terms of those entitlements. We have heard arguments from employers that they use that money and that it is part of their capital expenditure. We say that it should not be; it should be accounted for. For example, one very large company with 700 employees was taking deductions from employees' wages to pay for their mortgages, their medical insurance and other matters that related to them, not to the company, and the company actually used that money in the course of running its business when it collapsed. So there are problems if you rank banks higher.

CHAIRMAN—Sorry, was this employees' mortgages?

Mr Bastian—Yes, employees' mortgages, employees' medicals and employees' child-care payments they may have paid. The company provided a range of deductive services out of the employees' pay packets that were non-work related.

Senator WONG—Which were not then forwarded to the third party?

CHAIRMAN—They were not forwarded to the relevant bodies?

Mr Bastian—They were not forwarded to the third parties. The company was actually using that money and when they went broke all these people continued to owe money when they legitimately thought they had paid their mortgages, child-care payments and medical costs, and all those costs were subsequently owing.

CHAIRMAN—That would be a fraud, in a sense, rather than not making proper provision.

Mr Bastian—In all the examples we have put forward, there has never been a prosecution by ASIC.

Senator WONG—I am sure your union has had experience of this as well, but additional contributions to super is another area where this occurs. Have you had experience of employees saying, 'I'll put an extra five per cent in,' but the company has failed to pass that on to the superannuation fund, the company has then gone bust, and the employee has had wages deducted and the amounts—or a portion of the amounts—have not been forwarded on to the super fund?

Mr Bastian—Yes, that occurs. The example of the company I have just referred to is a clear example of where third-party payments have not been made. Our position is that the way to secure it is to take it out of the hands of the employer, have the employer account for it and have it placed in a recognised established fund—which is NEST.

CHAIRMAN—What is your response to the argument that at least some of these entitlements are contingent liabilities rather than actual liabilities? They only become liabilities if the company does go belly up. Therefore, you are restricting the company's access to capital by this requirement. Are you saying all those liabilities should go into the fund, including the contingent ones? What is your response to that argument?

Mr Bastian—The only really contingent liability that has any value is long service leave which, if you are on a federal award, is vested after 10 years. According to the provisions of the fund, you do not get the money unless you have actually vested it. The money still resides with the employer with the employer's account in NEST. If the employee leaves, that money reverts back to the employer. So that does not become an issue with the employer in terms of a contingent liability.

CHAIRMAN—But it is money that he has had to set aside. He might get it back in the event you have outlined, but it is money that is taken from his liquidity, if you like.

Mr Bastian—But from our perspective if the employer is running that close to the wind that it is using money that it should use for contingent liabilities then it is trading while insolvent.

Senator WONG—Just to recap, the AMWU's position is that you do not support maximum priority as the basis on which an employee's entitlements can be secured?

Mr Bastian—We do not see that as providing the necessary remedy for the problem.

Senator WONG—In fact, in your submission you advert to some of the issues that Senator Chapman raised about potential increased finance costs and/or limits on financing that might

result. The evidence is pretty clear that banks and other finance companies would at least limit how much they would lend. That makes sense to you, doesn't it?

Mr Bastian—I am sure they would be protecting their interests.

Senator WONG—That is right. Just getting back to what you do about it instead, dealing with this on a principle basis, one of the principles seems to me that we want to look at how one engenders behaviour change in directors. One option is the sort of trust fund approach that AMWU is taking in your industries. From a legislative perspective, another option proposed by one of the unions from which we have heard evidence was a change to the duties of directors, requiring directors in the annual report to make a statement as to the provision they had made for employee entitlements and, in the event that the company was wound up and those entitlements were not met, employees would have a right of action against the director personally for those outstanding entitlements. I suspect—and I do not know whether we explored this properly—that one of the policy imperatives behind that proposal was to try to get the behaviour change at director level—that is, you have to make provision for these entitlements.

Mr Bastian—We would not have a problem with that proposal. I think the proposal we put up about the reverse onus does more to engender change in their attitude. One of the great frustrations we have—particularly in the construction sectors, where it is probably more prevalent—is that you will have a company collapse and a director, same employer, will poke its head up somewhere else doing the same job, doing the same business. That for us is a frustration. There is no sanction against the behaviour of that director, whereas, if you put the reverse onus into legislation, they actually have to demonstrate to ASIC or someone else that they have exercised their duties properly or they are debarred.

Senator WONG—I think they are different issues, actually. I agree with you about phoenix companies. We have had a fair bit of evidence about that and I agree that there has to be some better regulation of the capacity of people to continue being directors in companies where they have a history of failing to pay out entitlements properly. I agree with that. I am not sure how we would go about that.

CHAIRMAN—It might have been other creditors.

Senator WONG—And other creditors. I think in the construction industry the scenario that we have had evidence about probably affects other contractors as well as employees. It might be that you would want ASIC to beef up its regulation of directors, the provision of information publicly about those directors—those sorts of things. The issue I am talking about though is more placing a positive onus on directors to actually turn their minds to the issue of provisioning. If they fail to do it and they make a statement that is unreasonable, that employees rely on, they then are personally liable. I would have thought that that is a pretty reasonable behaviour-changing imposition on directors.

Mr Bastian—Again, as I said, we would support that proposal; but for us it is a whole package about the issues we raised about law reform, including related entitlements and NEST.

Senator WONG—As for related entities, as you said, it is being able to lift the corporate veil where companies structure themselves such that assets are not in the employing entity.

Mr Bastian—I think the corporate veil is a different issue, because that is a doctrine of law about a sham arrangement.

Senator WONG—We should expand it, I think.

Mr Bastian—The issue I am talking about is a legitimate structure. The best example we had was with a company where we know that the administrator informed us that there was money that was siphoned off over to the Philippines to build the owner's boat; it had nothing to do with the company. Funds coming in were being used for means other than what they should have been used for. When we went to pursue that of course we could not get anything done with it. The owner had structured the company legitimately 20 years ago with the main primary asset in the family trust. In those circumstances, legally we cannot pursue that as the law currently stands.

Senator WONG—You would want some related entity provision?

Mr Bastian—It is a must, in our view, if it is to work. Otherwise you shift the problem from one of a sham arrangement to going and getting a couple of really good corporate lawyers or accountants to build you up a nice corporate rev that is completely legitimate and the asset is secreted away from employees.

CHAIRMAN—Is there a danger that if we shift the balance too far the incentive will be there for companies, in effect, to outsource various aspects of their processes—not to related companies but indeed to unrelated companies?

Mr Bastian—I think there is a growing problem with outsourcing in terms of employees now, but we still would not be able to get at, for example, a labour hire firm that has been used to employ all the employees. That is a different argument then about whether or not there is a common contract of employment that exists between the labour hire firm and the host company in such arrangements. That law is developing now.

Senator WONG—Regarding the issue of contingent and non-contingent employee liabilities, it seems to me that it is pretty hard for employers to argue they should not be making provision for actual liabilities. Contingent liabilities, such as severance pay, are contingent upon people being made redundant. The question that has been put to us—as you have probably guessed—is: why is it appropriate for me, as an employer, to make provision for an event that may never occur? How do you deal with that in terms of NEST? Is it simply a payroll based percentage contribution or do you make some actuarial calculation about what proportion of people in the industry are likely to be made redundant and have people pay a percentage calculated on the basis? How you deal with the issue?

Mr Bastian—What we sought to do with the proposal for NEST was to mirror what currently exists in the construction sector, where a severance component is paid weekly. From memory, that started back in the eighties, at $5 a week. I think it is currently running at $70 a week—

Senator WONG—Per employee?

Mr Bastian—per employee. In the NEST arena we have sought to move away from redundancy provisions and towards a severance provision that you would get regardless of whether you have been made redundant or you leave the industry, similar to the construction sector. That would get away from any problems in relation to how it is accrued; it is a recognised payment and they pay it weekly into the employee's account.

Senator WONG—On what assumptions have you calculated the employer's weekly contribution per employee?

Mr Bastian—As it currently stands, that is a matter of what we can achieve with the employer on the job. It is 'catch and kill your own' at the moment. The problem we have with the current legislation—which, for us, presents a problem in terms of GEERS—is that it is totally unrealistic. An eight-week cap is a nonsense. That is a basic minimum; it is certainly not a community standard.

Senator WONG—It is significantly below what many people would have as supposedly their minimum legal entitlement.

Mr Bastian—And it usually makes up the vast bulk of the money owed, without exception—that is, the vast bulk of money owed to employees. In one company that I gave as an example earlier, the average was $20,000 per employee. For a worker on $500 a week, paying a mortgage, that is a lot of money; it is an enormous amount of money for them to put at risk and lose.

Senator WONG—Do you have any specific suggestions about what to do with phoenix companies?

Mr Bastian—From our experience, in non-construction, the issue with phoenix companies is the reverse onus issue—to bar them. A phoenix company is normally an example of where the director has been involved in some activity to allow the dead limb to be severed and dropped deliberately. A good example may be an industrial accident where a worker has died and they are going to receive a heavy fine. They cut their losses and start up again. That is an example where you would want to have a reverse onus, so that they would have to demonstrate their bona fides to a proper authority, like ASIC, who can then make a proper judgment about whether or not they have discharged their onus in accordance with law; if they have not, they are out. As it currently stands, our estimate is that 98 per cent of them run the gauntlet.

Senator WONG—So you would have some sort of threshold test whereby if you have been involved in a company where employee entitlements had not been met once or twice—

Mr Bastian—It could simply be once, if the circumstances suited.

Senator WONG—ASIC would need to come to a view that you are a fit and proper person to become a director again.

Mr Bastian—They would have to come to a view that you remain a fit and proper person.

Senator WONG—Have you had any experience with the amendments to the Corporations Act—which were passed a couple of years ago, I think—relating to employee entitlements, which protected the entitlements of a company's employees from agreements and transactions entered into with the intention of defeating the recovery of those entitlements? Has that ever been applied to any of the liquidations that you have made reference to?

Mr Bastian—Not on any occasion that we have been involved in.

CHAIRMAN—Going back to the issue of phoenix companies, do the recommendations of the Cole royal commission go far enough?

Mr Bastian—I am sorry, I am not too up on all of the recommendations from the Cole royal commission.

CHAIRMAN—Have you got any particular recommendations from the AMWU as to how to deal with the phoenix company issue?

Mr Bastian—Only the ones that we have just mentioned.

CHAIRMAN—Since there are no more questions, I thank you very much for appearing before the committee and for your contribution to our deliberations.

Subcommittee adjourned at 4.35 p.m.