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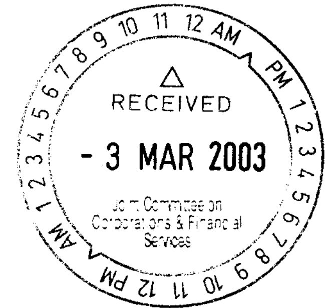
28 February 2003



The Secretary
Parliamentary Joint Committee on
Corporations and Financial Services
Room SG.64
Parliament House
Canberra ACT 2600
Fax – 6277 5719

Dear Sir/Madam

SUBMISSION TO THE INQUIRY INTO AUSTRALIA'S INSOLVENCY LAWS ("INQUIRY")

The Australian Institute of Company Directors (AICD) welcomes the opportunity to make a submission to the Inquiry. Thank you for granting us one month's extension to lodge our submission.

Over the last several years, AICD has submitted a number of submissions on aspects of the insolvency regime. In summary, AICD supports an insolvency review that is broad-based and takes into account the overall scheme of Australian insolvency law, rather than a review on selective insolvency issues.

Inquiry terms of reference – paragraphs a, d & g

The AICD participated in the preparation of the Voluntary Administration Law Reform Committee report to the Companies and Securities Advisory Committee ("CASAC") produced in May 1997. We continue to support the recommendations made in the above report and we rely on them for the purposes of the Inquiry.

Inquiry terms of reference – duties of directors

The AICD maintains its previously stated position that it is opposed to insolvency law reform which erodes the limited liability principle and penalises legitimate but unsuccessful commercial activity. The AICD looks forward to discussing specific reforms on this term of reference with the Inquiry.

Inquiry terms of reference - the treatment of employee entitlements

By letter dated 30 August 2002, the AICD lodged a submission to the Department of the Treasury in response to the Treasury's "invitation to comment" published on 30 July 2002 regarding proposed amendments to the *Corporations Act 2001 (Cth)* to introduce a "maximum priority" for employee entitlements. The AICD refers to that submission (enclosed) and relies on it for the purposes of the Inquiry. In short, the AICD expressed a number of reservations in relation to the proposed introduction of a "maximum priority" for employee entitlements. The AICD supports reforms on this aspect of insolvency law in terms of its previous submission to the Treasury.

Inquiry terms of reference - the reporting and consequences of suspected breaches of the Corporations Act 2001

The AICD refers to its submission (enclosed) in respect of the *Corporations Amendment (Repayment of Directors' Bonuses) Bill 2002* to the Secretary of the Senate Economics Committee dated 14 January 2003 and relies on it for the purposes of the Inquiry. In summary, the AICD submitted that the Bill ought to be amended as follows:

- substitute "extortionate" for "unreasonable" as the test, which would reflect the definition of *unfair loan*.
- exclude from the operation of the Bill:
  - remuneration paid to a director in accordance with the relevant company's constitution;
  - a payment made to a director with members' approval as required by s200B or Part 2E or under a contract so approved;
  - a payment exempted from the requirement for members' approval under s200B or Part 2E;
  - a payment under an indemnity which does not contravene s199A.
- alter the "reasonableness" test in s588FDA(1)(c) to provide that:

"(c) the transaction is so manifestly unreasonable having regard to:

(i) the benefits (if any) to the company of entering into the transaction; and

(ii) the detriment to the company of entering into the transaction; and

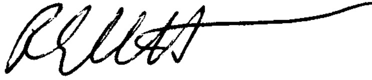
(iii) the respective benefits to other parties to the transaction of entering into it; and

(iv) any other relevant matter.

that no reasonable person in the company's circumstances could have entered into it."

Should you have any questions concerning our views on any of these matters, please do not hesitate to contact me on (02) 8248 6630 or Gabrielle Upton, Senior Policy Officer, on (02) 8248 6638.

Yours faithfully



Rob Elliott
National Policy Manager

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14 January 2003

The Secretary Senate Economics Committee
Suite SG.64
Parliament House
Parkes ACT 2600

Dear Secretary

Corporations Amendment (Repayment of Directors' Bonuses) Bill 2002

We refer to your letter dated 16 December 2002 requesting submissions regarding the Corporations Amendment (Repayment of Directors' Bonuses) Bill 2002 ("Bill"). We are strongly opposed to the Bill.

Since the commencement of the Corporations Legislation Simplification process in 1993, and particularly under CLERP, all significant changes to the legislation have gone through an extensive public consultation process before a change is introduced into the Parliament in the form of a bill. That has not been the case with this Bill. AICD has unsuccessfully endeavoured to have our views heard on this subject for over twelve months. Indeed, it has been disappointing that our more recent requests to the Government for a copy of the Bill were rebuffed.

You will be aware that there have been a number of amendments made to the *Corporations Act* dealing with the rights of employees, especially in the context of insolvency in recent years. These amendments were introduced because there was a concern that employee's interests were not properly protected if a company went into liquidation and there were insufficient funds available to meet all creditors. Many of these changes have not yet been tested in the courts. The AICD made a number of submissions in relation to these earlier amendments. It believes that until the courts have been given an opportunity to assess that legislation, no further changes should be made to the *Corporations Act*. Such continued legislative tinkering has the chance of leading to inconsistencies arising in the interpretation of the legislation with the further prospect that other important provisions may be found to be inadequate.

Bearing this mind, AICD is keenly aware of the events of the last eighteen months, which have led to the intense public focus on a number of high profile company collapses. We recognise that it is imperative to respond to such public concern in a timely and constructive manner. However, by addressing such concern in a precipitous fashion in the form of the Bill, the Government has missed the opportunity of firstly promoting the full enforcement of existing law in the area. Extra resources should be provided to the Australian Securities and Investments Commission to investigate and, if appropriate, take action against such directors. Only if such existing law is found to be lacking, should there be legislative reform.

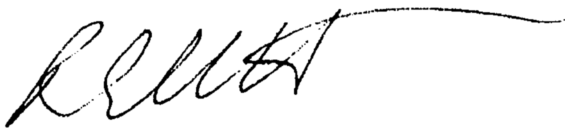
Moreover, the Bill in its current form focuses only on payments to directors, despite the fact that the current public controversy is centred on executive remuneration.

We also consider that the Bill could add considerable confusion, and litigation, to events surrounding company collapses. The difficulty of judging the 'unreasonableness' of a payment made up to four years earlier will probably lead to a proliferation of litigation. The Bill appears to require examination of the circumstances of the transaction through the eyes of a reasonable person at the time of the transaction. Will it be possible to disregard the benefit of hindsight in making this judgement? Most likely, the application of such a test will lead to arbitrary outcomes influenced by the fact that at some time within up to four years after the relevant transaction, the company went into liquidation. On this count, the Bill looks more like a means of punishing directors for the failure of their companies (irrespective of fault on their part) than a means of restoring value to creditors.

Although we are strongly opposed to the Bill in principle, we also recognise that it has momentum. We urge the Committee to address a number of aspects of the Bill that should be amended. Those matters are contained in schedule one to this letter.

Should you have any queries, please do not hesitate to contact me on (02) 8248 6630 or, Gabrielle Upton, Senior Policy Officer, on (02) 8248 6635.

Yours faithfully



Rob Elliott
Policy Manager

Schedule 1

- Substitute "extortionate" for "unreasonable" as the test for a director-related transaction in s588FDA that is potentially subject to the new regime. The definition would then reflect the definition of *unfair loan* in s588FD.

- Exclude from the operation of the Bill:

  - remuneration paid to a director in accordance with the relevant company's constitution;
  - a payment made to a director with members' approval as required by s200B or Part 2E or under a contract so approved;
  - a payment exempted from the requirement for members' approval under s200B or Part 2E;
  - a payment under an indemnity which does not contravene s199A.

- Alter the "reasonableness" test in s588FDA(1)(c) to provide to the effect that:

  "(c) the transaction is so manifestly unreasonable having regard to:

  (i) the benefits (if any) to the company of entering into the transaction; and

  (ii) the detriment to the company of entering into the transaction; and

  (iii) the respective benefits to other parties to the transaction of entering into it; and

  (iv) any other relevant matter;

  that no reasonable person in the company's circumstances could have entered into it".

Priority for Employee Entitlements

(30/08/2002)

Abstract

Submission to Mr Mike Kooymans, Acting General Manager, Corporate Governance Division, The Treasury

Details

Date: 30 August 2002
TO: Mr Mike Kooymans, Acting General Manager, Corporate Governance Division, The Treasury

PRIORITY FOR EMPLOYEE ENTITLEMENTS

The Australian Institute of Company Directors (AICD) is pleased to make this submission to the Department of the Treasury (the Treasury) in response to the 'Invitation to Comment' published by the Treasury on 30 July 2002 regarding proposed amendments to the *Corporations Act 2001* (Cth) (the Act) to introduce a 'maximum priority' for employee entitlements in the case of corporate insolvency.

General Observations

The AICD believes that, whilst the current proposal may not have far-reaching direct effects on Australian business, a number of significant adverse effects on Australian business may potentially flow from it. These effects include:

- the potential for this type of proposal to raise the costs of doing business generally and reduce Australia's international competitiveness;
- the tendency that such proposals have to undermine important principles of company law;
- the inevitable result that some businesses may enter into artificial commercial arrangements designed to avoid the operation of the proposed rule.

More specifically, the AICD is concerned that the proposal:

- inadequately defines how the proposal will impact on big as opposed to small business;
- represents a discriminatory impost on large businesses adding to general operating costs and to regulatory burdens that they already bear if there is an exemption for small business;
- defeats a fundamental element of insolvency policy, by which secured creditors are able to protect their rights substantially at the time they extend credit to an enterprise. It is also unclear how it will affect other principles of insolvency law such as the right of mutual set-off;
- creates considerable uncertainty regarding financing arrangements. Small and medium businesses are likely to find it more difficult to obtain finance, while the proposal to protect 'grandfathered' secured assets will result in different levels of security for different assets; and
- has been raised without alternative options for protecting the interests of employees being adequately explored.

Secured Creditors

Many common financing arrangements involve secured loans of the type that will be affected by the proposal. At present, the holder of a security over an asset is able to limit its exposure to a company's risk of failure, by taking the security. The consequence of taking security is that the security holder ranks above unsecured creditors in a winding up. A lender that is able to secure a loan will be more likely lend to an enterprise than it would be if it had no security. It is widely recognised that the availability of secured financing is important to small and medium enterprises (SMEs) which may otherwise find it difficult to obtain

finance. Additionally, the proposal could impact some types of businesses more than others. For example, manufacturing businesses tend to have large physical assets, which are often used to secure financing.

The proposal will deny secured lenders certainty about their financing arrangements in many cases. It will do this in at least two ways. First, the proposal will subordinate the rights of secured lenders to payment of employee entitlements, thus fundamentally changing the nature of the security. Secondly, it will become desirable for a lender to monitor the business of the company to which it has extended finance in order to ensure, for example, that the debtor company is able to meet its employee entitlement obligations without exposing the secured asset to the liquidation. In practice, this will be extremely difficult and will create a monitoring cost, which will most likely be passed onto the debtor company, if not more generally to businesses securing finance.

Moreover, if secured creditors become nervous about the possibility of the assets over which they have security being included in the liquidation and the distribution of an insolvent company's assets, then they may be likely to exercise their security and recover their loan earlier than would otherwise be the case. Permitting a liquidator to 'claw back' the proceeds of secured assets realised within six months of a company becoming insolvent may mean that lenders will want to be sure, or as sure as possible, that they have more than six months' comfort. Accordingly, insolvencies may well be brought forward, or may occur where otherwise they may not have occurred at all. Securities discharged within six months of the insolvency, where the lender had no reason to suspect that a business may become insolvent, may also be 'clawed back'. This would be unjust.

The overall effect of the proposal on secured lending is that it will provide lenders with less security. It will create difficulty for borrowers in obtaining finance, and it will lead to the insolvency of 'marginal' businesses that may otherwise have been viable in the long term. It should be noted that the definition of 'solvent' in the Act requires only that a debtor be able to pay its debts as and when they fall due, but not that the debtor be able to pay from its own money. In this sense, the availability of finance on reasonable terms is fundamental to the Act's provisions for dealing with insolvency and for distinguishing between solvent and insolvent companies.

A related issue is the effect on the rules regarding mutual set-off in the Act. These enable mutual debtors and creditors – that is, borrowers who are also lenders to that same enterprise – to set-off or 'cancel out' a portion of their liabilities. Typically this will apply where the relevant debts are unsecured. An anomalous result of reducing the rights of secured creditors is that they will be in a less secure position than unsecured creditors who are able to take advantage of the set-off rules in their dealings with the insolvent company.

Uncertainty in Financing

By significantly reducing the value to a lender of receiving security over an asset, the proposal will introduce considerable uncertainty into many financing arrangements. These include:

- creating difficulties regarding new drawings of credit under existing facilities, and revolving credit facilities such as overdrafts (which are important source of financing for SMEs);
- financiers being reluctant to take new security where they already have security interests that pre-date the new legislation (since grand-fathered security is to be protected from the new laws):
- in relation to revolving or varying facilities, making it difficult in practice to identify exactly the extent of secured interests that are protected by grandfathering arrangements.

The reduced certainty of secured lending will make it more difficult for businesses to grow. For example, the proposal will:

- attach an uncertainty factor to secured loans, thus changing the risk profile of borrowers and the cost of lending for a borrower (risk factors and premiums);
- inhibit new lending and business growth, and frustrate re-financing for businesses and lenders with existing security arrangements:
- create significant problems for businesses in any kind of financial difficulty by potentially accelerating insolvency (as noted above);
- lead to new and more stringent repayment and default terms being imposed on borrowers.

Since it is unclear whether the rules will operate on individual companies or corporate groups, undesirable

commercial outcomes potentially include:

- companies restructuring in order to place assets in companies separate from those which employ staff; and
- increased use of devices such as 'Romalpa' or retention of title clauses.

The uncertainty in financing arrangements may reach further: for example, it may affect other arrangements, which may be economically equivalent to a security (such as a securitisation), and other interests such as leases and contracts for services.

SMEs will directly feel many of these effects, although they are likely to be very disruptive to larger businesses as well, particularly in their dealings with SMEs.

Burden on Large Business

Part of the proposed amendments involves a possible exemption from the new rules for smaller businesses, though the means of determining a 'small business' are yet to be established. It is an unsatisfactory solution to the problems that would be created by the proposal, to simply exempt precisely the kind of business are most likely to become insolvent and therefore be unable to meet its liabilities to its employees. The proposed solution is unsatisfactory as a practical measure, and, in principle, is unsatisfactory to the extent that it introduces into the Act a form of unfair discrimination against large businesses.

Conclusion

The AICD considers that there are alternative approaches to the problem of protecting employee entitlements that are less intrusive into business activity, less burdensome, less uncertain, and likely to be more effective. The AICD would be happy to discuss these alternatives, details of which have been provided previously to the Treasury.

Yours sincerely

Rob Elliott
Policy Manager/Legal Counsel

File(s)