ABN 91 914 874 903

GPO BOX 5186 SYDNEY NSW 2001

DX 1285 SYDNEY

TELEPHONE: (02) 9231 3520

FACSIMILE: (02) 9221 9621

EMAIL: maxwilson@cla.org.au

WEBSITE: http:/ www.cla.org.au

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The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Room SG.64
Parliament House CANBERRA 2600.

Dear Secretary

Inquiry into Australia's Insolvency Laws

We thank you for the opportunity to provide submissions for the purposes of the Insolvency Law Inquiry. The following are our submissions relating to certain topics in the terms of reference of the inquiry. We would value the opportunity to have further input as proposed reforms are developed, including in relation to matters which we have not specifically dealt with below.

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

1. One area of concern is the conflict of interest, which tends to arise by reason of the appointment of administrators by incumbent management, pursuant to s. 436A(1).

2. The administrator is often appointed against a background of having been asked by the incumbent management to advise on the company's future. If the creditors resolve at their second meeting to enter into a Deed of Company Arrangement, then the administrator becomes administrator of the deed unless the creditors resolve otherwise (s. 444A(2)). If the company is wound up at the second meeting of creditors or upon the termination of a Deed of Company Arrangement the administrator automatically becomes liquidator (s. 446A(4)). Thus, the one individual may wear the following hats successively:

   - corporate adviser
   - voluntary administrator
   - deed administrator, and
   - where the deed is terminated and the company wound up, liquidator.

The conflict between role of adviser and of administrator

3. As administrator the practitioner is required to consider possible offences, breaches of duty and so on by directors (s. 438D) and must also advise creditors whether there may be voidable transactions liable to be set aside under Pt 5.7B of the Corporations Act (s. 439A(4)(b) and Reg. 5.3A.06). It is not uncommon for the potentially voidable transactions to involve directors as parties. Thus an administrator may well be required to act adversely to the individuals who sought his advice in the first place.

4. Further, the administrator may himself be a creditor of the company by reason of his previous advisory role, albeit that he is disqualified if the amount of the debt is greater than $5,000 (s. 448C(1)).

The conflict where deed administrator becomes liquidator

5. If a deed administrator becomes a liquidator of the company, as a consequence of the deed failing, it will be part of his new role to investigate the affairs of the company.

6. There may be serious matters to investigate in relation to the manner in which the administrator / deed administrator has carried out his task and/or the adequacy of the advice given to shareholders as to whether a deed should be pursued instead of winding up in the first place. Did the administrator mislead the creditors in his Report to Creditors? Did he deliberately conceal frauds of directors in order to get the deed approved? Did he fail in his duties as deed administrator thus adversely affecting returns to creditors?

7. A subsequent liquidator is in an advantageous position to assess whether the conduct of an administrator of a failed deed of company arrangement might call for consideration of such steps as an application to the Court under s. 447E. Further, a liquidator will, in appropriate circumstances, be required to lodge with ASIC a report under s. 533. Where there has been possible wrongdoing by an administrator or deed administrator, one would expect that an independent liquidator would consider what action should be taken and what reports should be lodged, whereas a liquidator who is the former administrator is in the ideal position to bury his mistakes or wrongdoing.

Countervailing considerations

8. There are countervailing considerations. Firstly, an administrator must be a registered liquidator and is thus subject to professional conduct requirements.

9. However, it is difficult to overcome the perception among creditors that an administrator is not impartial when appointed and, in cases where a deed fails, that his role as liquidator is to bury his mistakes and/or the wrongdoing of his appointors. Administrators and liquidators perform important statutory functions, including quasi-judicial, and it is important that there be public confidence in the integrity of the system by which they are appointed.

10. Secondly, there are provisions in the Corporations Act which enable administrators and liquidators to be removed, replaced or investigated by the Court, and/or replaced by vote of creditors.

11. However, to unseat an incumbent administrator by court action costs money and will not succeed unless real grounds, in the particular case, are shown (that is, a court will not remove a liquidator or administrator simply because creditors perceive that he lacks impartiality). To unseat an incumbent administrator, or to appoint someone else in the event of a company entering into a deed of company arrangement or being wound up, requires a majority vote of creditors by number and value. Creditors do not necessarily know or trust each other and do not necessarily have identical interests. A creditor may not trust another creditor's nomination for administrator/ deed administrator/ liquidator any more than he trusts the incumbent.

Proposed reform

12. Consideration should be given to a roster system for the initial appointment of administrators. Alternatively, an administrator appointed by directors might be appointed as "acting administrator", pending the first meeting of creditors, at which point the default position is that an administrator is appointed from the roster, but the creditors may instead resolve to confirm the appointment of the acting administrator or appoint a different person as administrator. The important feature of the latter version of the regime is that, if a resolution is not passed, then an administrator from the roster is appointed.

13. Consideration should also be given to a separate roster system for the appointment of a liquidator in the event that a company goes into liquidation upon termination of a deed under s. 445E.

14. It is submitted that, if the above measures are enacted, a roster system would not be necessary for the appointment of either a liquidator or deed administrator at the second meeting of creditors to decide the company's fate, because at that point the incumbent has been in place for only a short period of time and is either independent (through selection from the roster) or supported by the majority of creditors by value and number.

15. In the event that directors are to be allowed to appoint an administrator (or acting administrator, if the second of the above proposals is adopted), then it should be necessary for an administrator to advise creditors, in his first report, of any prior association with the company or its directors and any debts owed by the company to the administrator.

(b) The duties of directors;

16. No comment

(c) The rights of creditors;

17. See the submissions under heading (e)

(d) The cost of external administrations;

18. No comment

(e) The treatment of employee entitlements;

19. The treatment of employee entitlements involves a contest between the pari passu principle which is fundamental to insolvency law and the perceived desirability of giving special protection to particular classes of creditor claims. Determining where the balance should struck involves broader considerations of social and economic policy.

20. It is not proposed to comment on how these broader issues should ultimately be resolved. However, it should be pointed out that, in respect of employee entitlements (or each category thereof), the choice need not be simply between according them priority and treating them as ordinary unsecured debts.

21. Under the current system for priorities (Corporations Act ss. 556 and 559), each category of priority claims must be paid in full before the next category is entitled to payment, and only when all priority claims have paid in full do ordinary unsecured creditors stand to receive a distribution.

Proposed reform

22. An alternative regime may be contemplated which would accord priority but not in this "all or nothing" manner. For example it might be enacted that – say – 30% of funds available for distribution, after certain priority claims had been paid in full (such as those in s. 556(1)(a) to (de)) are to be distributed to unsecured creditors automatically. The remaining 70% would be distributed as per the existing regime, and, to the extent that any priority creditors do not receive full payment, they would be treated as unsecured creditors and thus able to share in the remaining 30%. Such a regime would ensure that priority creditors including employees will continue to have their priority, but ordinary unsecured creditors will be more likely to receive a share in the proceeds on winding up.

23. The priority claims to which such a regime would apply, and the percentage of such claims affected, are matters to be determined on the basis of broader considerations.

24. Importantly, such a regime would give the legislature an opportunity to strike a balance between the pari passu principle and the perceived need to give extra benefits to particular classes of creditor.

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

25. No comment.

(g) Compliance With, And Effectiveness Of, Deeds Of Company Arrangement

26. One matter which we have identified as being a problem which may impact on the effectiveness of some deeds of company arrangement is the inability of an administrator or a deed administrator to release parties from

potential liability under the voidable transactions provisions under Part 5.7B of the Corporations Act.

27. Sometimes, the viability of a deed of company arrangement will depend upon the ability of the administrator to persuade directors and other parties who have received payments from the company, which could be avoided under Part 5.7B if the company were wound up, to refund such payments in part. The benefit to such parties is that the administrator will recommend that a deed of company arrangement be pursued and, if the deed succeeds, then the company will never be wound up and thus a liquidator will never commence recovery action against them for a potentially greater sum. However, an administrator cannot guarantee that the deed will succeed. The company concerned may ultimately go into liquidation. The liquidator, once appointed, has the right to commence action to recover in respect of voidable transactions. Thus a person who has made a payment in good faith in the hope of avoiding exposure to recovery proceedings may ultimately still be sued by the liquidator.

28. This is unfair and is a potential disincentive to persons agreeing to repay money to a company administrator for the benefit of creditors. If a person pays money to the company's creditors (effectively), to avoid recovery proceedings, that person should be able to assume that he will not later be targeted by such proceedings. Putting the matter another way, it will be easier for an administrator to persuade parties to part with money for the purpose of getting up a deed if the administrator can give an effective promise that, should the deed fail, a liquidator will not be able to commence recovery action against them.

29. The source of this problem is the nature of the cause of action under s. 588FF as an action which is personal to the liquidator, and which, accordingly, does not accrue unless and until a company is wound up. This is entirely appropriate. However, the concomitant is that a liquidator, and only a liquidator, may settle a claim under s. 588FF. An administrator cannot.

Proposed reform

30. It is submitted that the law should be changed to enable an administrator to give an effective release, binding on any subsequent liquidator, to any party in respect of potential liability under s. 588FF, where this is done in conjunction with, or for the purpose of, a deed of company arrangement.

31. Safeguards for such a provision would include a requirement to disclose the terms of such release, its effect, the potential claims to which it relates and its relationship to the proposed deed, in the Administrator's report to creditors. The creditors would thus have the opportunity to prevent such a release being given, by voting against the deed.

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

32. No comment

Yours faithfully

Daren Armstrong
Secretary
Legislative Review Task Force.