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28 April 2004

Dr Kathleen Dermody
Committee Secretary
Parliamentary Joint Committee on Corporations & Financial Services
Parliament House
CANBERRA ACT 2600

Dear Dr Dermody

Re: Inquiry into Australia's insolvency laws

With apologies for the delay in forwarding this to you, please find attached my submission to the Inquiry on Australia's Insolvency Law by the Joint Committee on Corporations and Financial Services.

Yours sincerely

Rosalind Mason

Rosalind Mason

SUBMISSION TO THE PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

on

ASPECTS OF THE ISSUES PAPER: IMPROVING AUSTRALIA'S CORPORATE INSOLVENCY LAWS

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22 May 2003

Introduction

The appointment, removal and functions of administrators and liquidators

Is there a need to further strengthen the independence of administrators? What additional measures may be adopted to do so?

No comment is made on this issue other than to note that perceived independence of the administrators underpins much of the public confidence in the insolvency regime in Australia. There appears to have been quite a high degree of confidence in the independent insolvency practitioners who were appointed, for example, in the high profile and emotive Patricks and Ansett administrations. If public confidence is compromised, then there may be calls for more black-letter regulation which would probably not be helpful in the vast majority of cases.

The Committee invites comment on measures for dealing with assetless companies and the role that liquidators can play in relation to assetless administrations.

This issue is related to the issue discussed below of whether there should be a unified legislative and administrative framework for corporate and personal insolvency. Assetless administrations are essentially handled in personal insolvency by the public sector, albeit charges are made on trustee realisation of estates. (*Bankruptcy (Estate Charges) Act 1997* (Cth).)

Would it be appropriate to extend the timeframe for the first and second statutory meetings of creditors under voluntary administration?

Part 5.3A *Corporations Act* is not an area of special research interest and so I do not comment in detail on this issue nor on the suggested solutions. That is, except to say that an objective of Part 5.3A, to maximise the chance of as much of a

company's business as possible continuing, may well require that one size (for procedure) should not be made to fit all insolvency administrations. The reference to CAMAC on restructuring of large enterprises may produce recommendations on the effect of these time limits for large scale voluntary administrations.

One of the time-consuming aspects of an insolvency administration can be dealing with retention of title claims. On this aspect, it is noted that the Australian Law Reform Commission delivered an (Interim) Report No 64 on *Personal Property Securities* in 1993. (http://www.austlii.edu.au/au/other/alrc/publications/reports/64/) It recommended the registration of purchase money security interests (paragraph 7.5). If action is not being taken in Australia to redress the inequities and inefficiencies caused by lack of notice of such security interests, then perhaps it would be timely to reconsider this ALRC Report. (New Zealand introduced major reform to its Personal Property Security law during 2001.)

The duties of directors

In an insolvency or a 'pending insolvency' context, can the law better define the duties and responsibilities of directors?

Based on anecdotal evidence gleaned through teaching students in the Advanced Insolvency Law & Practice external courses at USQ, I would support the submission that one of the most difficult tasks that confronts an insolvency practitioner is establishing when a company became insolvent. A useful paper on this topic, to which I refer students and which I commend to the Committee, is by Dr David Morrison "When is a company insolvent?" (2002) 10 *Insolvency Law Journal* 4.

Also in 1998, an accounting colleague, Dr Anne Wyatt now of Melbourne University, and I published an article on "Legal and Accounting Regulatory Framework for Corporate Groups: Implications for Insolvency in Group Operations" (1998) 16 *Company & Securities Law Journal* 424. A particular issue which was highlighted in the writing of the piece is that two disciplines (accounting and law) which underpin insolvency practice often use the same terms but attribute different significance to those terms. In a court case, lawyers will rely on expert accounting evidence to "prove" that a company was solvent or insolvent at a particular point in time and yet the accounting evidence in support thereof may not be clear-cut.

The law's cash flow test of solvency relies on the relative correspondence of accounting information. Cash flow statements required under AASB 1026 *Statement of Cash Flows* as components of semi-annual and annual reports do not provide this information. The cash flow test of solvency under the law is the ability to pay debts as and when they become due, and is concerned with whether there is sufficient cash to meet debts from cash on hand, collection of current accounts receivables and sales of inventory and any other current liquid assets. Directors in their ongoing obligation to attest to the entity's solvency as well as insolvency administrators are concerned with the availability and liquidation valuation of assets. The Statement of Cash Flows alone does not provide this information.[1]

Likewise, the balance sheet which can be a source of additional evidence has problems associated with it. The allocative process (of costs and revenues to periods when the benefits are realised) is conceptually inconsistent with legal solvency measures, which are concerned with orderly liquidation valuations of current net cash flows. One solution suggested in the article to this problem of accounting regulation and proof of insolvency was to dispense with the going concern assumption.

The rights of creditors

Is there a case for a unified legislative and administrative framework for corporate and personal insolvency?

My research undertaken on multistate insolvency law has highlighted difficulties that have arisen from a jurisdictional perspective with corporate insolvency law when it is not regulated federally - despite the Commonwealth Constitution conferring power to legislate with respect to "bankruptcy and insolvency" on the Commonwealth.[2]

Insolvency law is part of nation-wide commercial and economic processes and it affects international trade and investment. The state's interest in the promotion of confidence in a market economy and in commercial enterprise, for example through

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[1] Divergence between cash flows and net income is an indicator of solvency risk, and the extent of an entity's cash flow volatility is identified by the firm's cash budget, which may not be reported. See J A Loftus & M C Miller, "Solvency Assessment and Financial Reporting", (1996) 20 (2) *Accounting Forum* 97 and J A Loftus & M C Miller, *Reporting on Solvency and Cash Condition* (Australian Accounting Research Foundation, Melbourne.

[2] Section 51(xvii) *Commonwealth Constitution.*

its policies on insolvency risk allocation and commercial morality, is best addressed on a national basis.

The regulation of business failure should not distinguish between whether a business operates through a natural person (as sole trader or member of a partnership) or a separate legal entity such as a limited liability company (although there may be special regulation eg for authorised deposit-taking institutions). As noted by Professor Andrew Keay, the general principles governing bankruptcy of a natural person and liquidation of a corporate debtor are the same.[3]

In the United Kingdom these matters are regulated in the one statute, *Insolvency Act 1986* (UK), and in the United States in the *Bankruptcy Code* (USA). The Law Commission of New Zealand has recommended the enactment of a single statute dealing with all insolvency regimes in an Advisory Report to the Ministry of Economic Development.[4] The draft UNCITRAL Legislative Guide on Insolvency Law and recent international developments, such as the European Insolvency Regulation; and the UNCITRAL Model Law on Cross Border Insolvency, do not distinguish in a general sense between principles for insolvent corporate debtors and individual business debtors. Also a unified Act is more user friendly, especially for foreigners like prospective foreign investors.[5]

Unified federal legislation in personal and corporate insolvency would have a number of advantages. From the jurisdictional perspective, it would achieve an Australia-wide area with which a relevant connection is to be established and within which the court's judgments will prima facie have direct or automatic effect. Intra-national disputes would be minimised and it would be simpler for foreign courts to interact with a single federal jurisdiction.

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[3] Keay A, 'The Unity of Insolvency Legislation: Time for a Re-think?' (1999) 7 *Insolvency Law Journal* 4 at 9.

[4] Law Commission, *Insolvency Law Reform: Promoting Trust and Confidence*, Wellington, 2001 at chapters 27 and 28.

[5] The South African Law Reform Commission, *Report on Review of the Law of Insolvency*, Project No 63, Pretoria, 2000 at 25. http://wwwserver.law.wits.ac.za/salc/report/63vol1_1.pdf

Should Australia adopt a debtor in possession business rescue regime along similar lines to Chapter 11 of the US Bankruptcy Code as an alternative to, or in place of, VA?

Insolvency laws are becoming recognised as essential to the regulation of market economies.[6] As noted during the World Bank's consultation process leading to its Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems:

> The creation of ... a framework [for an insolvency system], and its integration within the wider context of the established legal process, are vital to the maintenance of social order and stability in the fullest sense: all parties in interest need to be in a position to anticipate their legal rights in the event of the debtor's inability to pay, or to pay in full, whatever is due to them in consequence of their dealings and relationship. This in turn enables them to make calculations regarding the economic implications of such default by the debtor, and hence to estimate risk.[7]

According to Australian research, policy dealing with insolvency is more significant than might be expected, given the relatively small proportion of businesses which exit because of business failure.[8] Regulatory provisions for business insolvency affect more than just those related to the failing business. They 'affect economic incentives more broadly by changing the willingness of people to lend money to businesses, and the level of prudence adopted by entrepreneurs.'[9] They also affect the number of businesses that become insolvent and they can 'partly determine the extent of reorganisation of resources in an economy over time, with potential long run impacts on overall business dynamism and productivity.'[10]

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[6] Evidence for this can be found in the Report of the Australian Task Force on International Financial Reform and the steps being taken by the United Nations Commission for International Trade Law ('UNCITRAL') (Draft Legislative Guide on Insolvency Law), the World Bank (Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems), the International Monetary Fund (Report of the Working Group on International Financial Crises) and others to promote reform of insolvency systems.

[7] World Bank, 'Draft Background Paper: Building Effective Insolvency Systems: Toward Principles and Guidelines', Paper presented to the *Conference on Insolvency Systems in Asia: An Efficiency Perspective*, Sydney, 1999 at 1.

[8] Bickerdyce I, Lattimore R & Madge A, *Business Failure and Change: An Australian Perspective*, Productivity Commission Staff Research Paper, Ausinfo, Canberra, 2000.

[9] Bickerdyce I, Lattimore R & Madge A, note 8 at 76.

[10] Bickerdyce I, Lattimore R & Madge A, note 8 at 77.

The 'close relationship between economic results and legal solutions' in the field of insolvency[11] is evident in that insolvency law finally allocates the losses in the event of financial failure of a business. It underpins the commercial and financial dealings in a market economy[12] and the choices it makes are also a crucial indicator of the attitudes and fundamental values of the state's legal system.[13] Nevertheless, insolvency law is not merely of economic significance to the community.[14]

It is intimately linked to the commercial, financial and social fabric of a state,[15] being an important contributor to the state's commercial and economic processes and an important component of the state's general commercial laws.[16] In 1995 Wood categorised states as 'pro-creditor', 'pro-debtor' or disinterested in their approach to insolvency.[17] The former allow creditors to protect themselves against insolvency, for example through security interests, while the pro-debtor approach is exemplified by rehabilitative regimes. The 'disinterested' category includes fundamentalist Muslim states and states without a commercial tradition. Examples of the principal distinctions between a more pro-creditor or pro-debtor stance include differing attitudes to the roles of banks, the role of the debtor (as struggling

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[11] Burman HS, 'Harmonization of International Bankruptcy Law: A United States Perspective' (1996) 64 *Fordham Law Review* 2543 at 2548.

[12] Wood PR, *Principles of International Insolvency*, Sweet & Maxwell, London, 1995 at 1.

[13] Wood PR, note 12 at 1.

[14] Warren E, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775; Gross K, *Failure and Forgiveness: Rebalancing the Bankruptcy System*, Yale University Press, New Haven, 1997. At 218, Gross discusses *In re Abacus Broadcasting Corp* 154 BR 682 (Bankr WD Texas 1993) in which a judge considered the impact of insolvency on a small community in the context of choosing venue for a reorganisation case under Chapter 11 *Bankruptcy Code* (USA) between the location of the debtor's owner and the location of the debtor's actual business, its primary secured lender, its creditors and its employees.

[15] Fletcher IF, 'Cross-Border Cooperation in Cases of International Insolvency: Some Recent Trends Compared' (1991-1992) 6/7 *Tulane Civil Law Forum* 171 at 175.

[16] See the guiding principles adopted in the Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45, vol 1, Australian Government Publishing Service, Canberra, 1988 at para 33. The World Bank's Principles on the Legal Framework for Corporate Insolvency state they should 'integrate with a country's broader legal and commercial systems': World Bank, *Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems*, 2001 at Principle 6.

[17] Wood PR, note 12 at 2-3.

entrepreneur or as necessarily venal or incompetent),[18] and the sanctity of contract[19] as opposed to the need for third party protection.[20]

The embedding of insolvency law in the commercial, financial and societal culture of a state together with the complex interaction of the range of laws relevant to an insolvency administration[21] tend to militate against harmonisation between states of the resolution of multistate insolvency issues.[22] It also militates against ready adoption locally of an insolvency regime from another jurisdiction.

Within common law jurisdictions such as England and Australia, insolvency officeholders are typically accountants, who employ specialist lawyers to assist with commercial litigation and advice work. The reason for this, according to Lord Hoffmann, is the importance of the floating charge to the development of English insolvency law and practice. The persons appointed by the banks as receivers to take charge of the conduct of the business and the realisation of the assets were traditionally accountants.[23]

In other jurisdictions, such as the United States, lawyers are appointed to insolvency administrations and employ specialist accountants as required. This difference between which branch of the professions has the control of insolvency administrations affects insolvency practice. Lord Millett compares practice in England and the United States as follows:

> The difference is also explained by the fact that insolvency in the United States is handled by lawyers, who prefer to negotiate deals between competing interests and leave the business to be run by existing management; in the United Kingdom, however, insolvency is dealt with by accountants, who share the creditors' contempt for the existing management whose incompetence has

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[18] For example, its quasi-criminal sanctions of pre-insolvency debtor and creditor behaviour.

[19] For example, its effect on creditors' rights to enforce their securities.

[20] Westbrook JL, 'A Comparison of Bankruptcy Reorganisation in the US with the Administration Procedure in the UK' in Leonard EB & Besant JW (eds) *Current Issues in Cross-Border Insolvency and Reorganisations*, Graham & Trotman and International Bar Association, London, 1994 at 36-7.

[21] Insolvency law is not 'easily severable from the remaining rules of the legal system': Anton AE, 'Note of Reservations by Mr A E Anton' in United Kingdom Bankruptcy Convention Advisory Committee, *Report on the EEC Preliminary Draft Convention,* Cmnd 6602, Her Majesty's Printing Office, London, 1976 at 120; United Kingdom Insolvency Law Review Committee, *Report on Insolvency Law and Practice*, Cmnd 8558, Her Majesty's Printing Office, London, 1982 at 116.

[22] Fletcher IF, note 15 at 175.

[23] Lord Hoffmann commented extra-judicially: 'The result is that British insolvency practitioners are to this day almost entirely accountants who are, in their capacity as receivers, used to having virtually unlimited powers over the assets of insolvent corporations.' Hoffmann L, 'Colloquium: Cross-Border Insolvency: A British Perspective' (1996) 64 *Fordham Law Review* 2507 at 2508.

> ruined the business and who prefer to take over the management and leave the competing interests to be dealt with according to fixed legal rules.[24]

Lord Hoffmann is in favour of allowing the insolvency practitioners to take charge of insolvent businesses and to represent creditors' interests. He considers that the role of the courts should be limited. At the initial stage of an insolvency administration, court involvement may impose obstacles on a quick business solution.[25]

Should solvent group companies be required to contribute to the losses of other group companies in liquidation? If so, in what circumstances?

On this issue, I quote extracts from Wyatt A & Mason R, "Legal and Accounting Regulatory Framework for Corporate groups: Implications for Insolvency in Group Operations" (1998) 16 *Company & Securities Law Journal* 424 at 447-450 – noting that the information upon which it was based has not been revised:

"It has been shown that a capital boundary problem exists in modern corporate law. It has been argued that the fundamental principles underpinning the legal and accounting frameworks for commercial vehicles do not adequately address the issues that have evolved with corporate groups. Discrepancies exist between the law's regulation of separate legal entities, and the reality that single entities may be controlled and operated as part of a larger economic enterprise. Discrepancies also exist between accounting and legal concepts that affect the usefulness of the financial information upon which the law relies, for example in respect of the cash-flow test of insolvency. At the core of these inconsistencies are the twin problems of uncoordinated rule-making among corporate law and accounting regulators, and dichotomous literal interpretation versus the fuzzy law approach adopted by the legal and accounting regulators respectively. However it is clear that legal and accounting regulation are closely entwined, especially when insolvency strikes.

Directors' duties owed to a particular company can be unrealistic when their company is operated with other member companies for the group benefit. The courts

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[24] Millett P, 'Cross-Border Insolvency: The Judicial Approach' (1997) 6 *International Insolvency Review* 99 at 109.

[25] Hoffmann L, note 23 at 2520.

are constrained in applying a group responsibility solution because corporate groups do not exist for most purposes under the *Corporations Law*. Cognitive dissonance also sets in where group management and group accounting practices are examined within the current legal and accounting regulatory framework.

Legal regulation of companies is based upon doctrines of limited liability and the single legal entity principle which produce uncertain outcomes for members and creditors in respect of the availability and distribution of assets if insolvency strikes. Accounting regulation does not deliver financial information directly relevant to assist liquidators and the courts because accounting and legal concepts lack consonance.

The key reform proposed is that there be explicit recognition of the existence of corporate groups.[26] ... Thus the law would recognise individual companies operating as part of an economic group. Directors may make decisions to act for the benefit of the group rather than individual corporate (single) entities.[27] In the event of insolvency, courts may make contribution and pooling orders, where it is just and equitable for the court to do so. As in the New Zealand experience, guidelines would be included in the provisions for the court as to the nature of the interrelationships among the group of companies, and the interests of shareholders of some, but not all, of the companies would be one matter for the court to take into account. In answer to the possible dampening effect that this might have on entrepreneurial activity, Austin suggests that limited liability could be preserved where financial segregation and capitalisation or insurance of the subsidiary can be proved.[28]

... In conclusion then, the following reforms are proposed: first, development of legal rules relevant to corporate group vehicles; second, integration of legal and accounting precepts and regulation, developed jointly to keep pace with commercial practices; and third, amendment of insolvency laws to promote fair and orderly processes and collective equity in a group context."

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[26] See United Kingdom Insolvency Law Review Committee, note 21, chapter 51.

[27] Note *Companies Act* 1993 (NZ) s 131.

[28] R P Austin, "Corporate Groups", in C E F Rickett & R B Grantham (eds), *Corporate Personality in the 20th Century*, (Hart Publishing, Oxford, 1998), p 89.

The treatment of employee entitlements: Should employee entitlements have an absolute priority ahead of all other creditors, including secured creditors, upon liquidation?

I have no comment to make on this issue, save that such a step would require much consultation and consideration given the potentially wide-ranging effects on commercial practice. (Note comments above about the embedding of insolvency law in the commercial, financial and societal culture of a state together with the complex interaction of a wide range of laws.) This super-priority should only be one of the suggestions explored to address the underlying concern about the fate of employees in a corporate insolvency.