Chapter 2

Issues raised in evidence

2.1 This chapter deals specifically with issues canvassed in submissions to the inquiry and with witnesses at the public hearing. Not all of the committee's recommendations from its 2004 *stocktake* report referred to in the terms of reference are addressed in this report. However, the following recommendations are considered in some detail:

- uncommercial transactions (recommendation 13);
- creditors' voluntary liquidation (recommendation 54);
- administrators' casting vote (recommendation 3);
- prohibition on termination of contracts (recommendation 55);
- reconstructing financial records (recommendation 10);
- disqualification provisions (recommendation 31);
- superannuation entitlements (recommendation 47); and
- assetless companies (recommendation 29).

Regulation of the insolvency process

Uncommercial transactions and clawback provisions

2.2 The issue of uncommercial transactions gave rise to a number of divergent views and competing claims from Treasury and the main insolvency and accounting bodies. The committee's consideration of issues surrounding uncommercial transactions during its previous inquiry led it to conclude and recommend that the requirement to establish insolvency be removed as a prerequisite for the avoidance of uncommercial transactions which may be challenged by a liquidator.[1] Such transactions are to have taken place during the two year period preceding formal insolvency. The committee's view at the time, which is unchanged, was that the requirement to establish insolvency is unduly restrictive and can impede the recovery of property of the company for the benefit of creditors.[2]

2.3 The Government rejected the recommendation on the grounds that the proposal has the potential to cast doubt on many company transactions and disrupt business. The Treasury submission to the current inquiry provided further detailed commentary in support of the Government response. The submission noted that removal of the insolvency prerequisite:

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.63

2 ibid.

- would arguably make the corporate insolvency provisions too broad and allow liquidators to call into question many of the transactions that a company may have entered into in the two years prior to the commencement of the liquidation;
- may cause injustice to third parties that have dealt in good faith with the company; and
- may increase the cost and duration of many insolvency proceedings, often with little ultimate benefit to creditors.[3]

2.4 Treasury concluded its submission by drawing attention to the importance of differences in claw back provisions which apply to natural persons under the *Bankruptcy Act 1996* from those which apply to corporations under the *Corporations Act 2001*:

> Generally corporations engage in a greater number and size of transactions than most individuals. If a similar approach were taken in corporate insolvency it would cast doubt on a greater number of transactions with consequent business uncertainty. It is appropriate that the rules for personal bankruptcy and corporate insolvency differ in some areas to reflect the differing significance of competing policy considerations.[4]

2.5 The committee notes that the Law Council submission also opposed the recommendation:

> When a company is solvent the interests of the shareholders should prevail over the interests of creditors. When a company is insolvent the interests of creditors should prevail.
>
> The Insolvency Committee [of the Law Council] believes that to remove the insolvency prerequisite changes the focus of the transaction (effected when the company is solvent) to one concerning the interests of creditors rather than the interests of shareholders.[5]

2.6 The committee notes that the Insolvency Practitioners Association of Australia (IPAA) and the accounting bodies did not appear to give much credence to the arguments put by Treasury in evidence before the committee. The IPPA saw merit in the committee's recommendation and the accounting bodies offered in principle support. Policy Adviser for CPA Australia, Mr John Purcell, argued that the principle of maintaining certainty before in the law is important. Any significant and material differences between personal and corporate bankruptcy claw back arrangements should be kept to a minimum and rationalised in a form that is understood by business.[6]

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3 The Treasury, *Submission 10*, p.5

4 ibid.

5 Law Council of Australia, *Submission 13*, p.1

6 *Committee Hansard*, 5 March 2007, p.30

2.7 However, the IPAA and the accounting bodies argued that caution is required in drafting any amendment to bring relevant provisions of the Corporations Law into line with the equivalent regime under the Bankruptcy Act. The IPAA summed up the position clearly:

> A fine line needs to be drawn between giving liquidators the necessary powers to set aside transactions which are intended to defeat creditors' interests, and enabling directors to implement a legitimate corporate reorganisation, which is in the interests of the company, its creditors and employees.[7]

2.8 The accounting bodies' submission also raised the important point that an amendment to the Corporations Act would need to ensure that the interests of third parties dealing at arms length are not adversely affected, and that allowance be given to directors' reliance on the business judgement rule in managerial decision-making.[8]

2.9 The committee supports the views of the IPAA and CPA Australia and notes further that the risk of an injustice to third parties occurring has probably been overstated by Treasury. This is because, as the IPAA pointed out at the hearing, the widely accepted definition of uncommercial transaction is a fairly narrow one:

> …we are talking about the types of transactions that potentially have not been in the best interests of the company, to which the directors owe their primary fiduciary duty. I cannot imagine too many transactions of the type that would be potentially voidable that have not been entered into with some related party for some ulterior purpose.[9]

2.10 The committee believes it is important to find the right balance between the interests of creditors and shareholders in any change to the claw back provisions. This remains a grey area of law because of the difficulty identifying an exact point in time in which a company is insolvent. One option raised at the hearing by a representative of CPA Australia would involve making the threshold for the uncommercial transaction regime less restrictive by shortening the period from 24 to 12 months.[10] The committee believes there is merit in shortening the period in which a liquidator may challenge company transactions.

Recommendation 1

2.11 The committee reinforces its support for the principles of recommendation 13. The committee recommends that insolvency be removed as a prerequisite for the avoidance of uncommercial transactions which may be

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7 Insolvency Practitioners of Australia, *Submission 3*, p.2

8 The Institute of Chartered Accountants in Australia and CPA Australia, *Submission 12*, p.3

9 Mr John Melluish, National President, Insolvency Practitioners Association of Australia, *Committee Hansard*, 5 March 2007, pp.37-38

10 Mr John Purcell, Policy Advisor, CPA Australia, *Committee Hansard*, 5 March 2007, p.28

challenged by a liquidator. Such transactions are to have taken place during the one year period preceding formal insolvency.

Creditors' voluntary liquidation

2.12 As stated in its recommendation 54, the committee is of the view that the law should allow for a company's swift and efficient liquidation to maximise recoveries for the benefit of creditors. The committee believes that the creditors' voluntary liquidation (CVL) procedure should be retained and directors should be able to immediately place a company into liquidation.[11] The Government rejected this recommendation on the grounds that it would give directors of companies an 'inappropriate power'. Treasury officials told the committee at its hearing that in a dispute between directors and members, the directors could threaten to place the company into liquidation, '…and there is very little the members could do to reverse that process once it had commenced'.[12]

2.13 The committee notes there are a range of views as to the appropriate legislative response. The joint submission from the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia supported the proposal to enable directors to resolve to appoint a liquidator:

> …this would enable the voluntary administration procedure to more clearly function with its intended purpose of facilitating business recovery. Caution would nonetheless be required in any legislative drafting to safeguard, in appropriate circumstances, the interests of members.[13]

2.14 The committee agrees with the Law Council's view that the existing procedures are neither efficient, practical nor cost effective in a large number of cases where the directors are also the members:

> There are a large number of cases where a company goes into voluntary administration because it is easy and convenient for that to occur. When that occurs…an investigation is conducted, a section 439(a) report is prepared and two creditors meetings are held. Our view is that in a lot of cases they are wasted resources—wasted creditors' funds if you like. We support the view that it should simply be in the capacity of the directors to say, 'The company is insolvent; there is no help or prospect of anything other than a liquidation; we will be able to resolve…to appoint a voluntary administrator to appoint a liquidators'.[14]

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11 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.215

12 Mr Matthew Brine, Manager, Government and Insolvency Unit, Corporations and Financial Services Division, Markets Group, The Treasury, *Committee Hansard*, 5 March 2007, p.9

13 The Institute of Chartered Accountants in Australia and CPA Australia, *Submission 12*, p.7

14 Mr David Proudman, National Chair, Insolvency and Reconstruction Committee, Business Law Section, Law Council of Australia, *Committee Hansard*, 5 March 2007, p.52

2.15 The committee notes that the Government has partially addressed this issue in items 89 to 91 of the draft bill by improving the existing process for the commencement of CVLs. According to the IPAA, the proposal included in the bill was negotiated with Treasury 'to achieve what we saw as a vast improvement over the existing CVL process and at least make creditiors voluntaries a more viable option for directors when they are looking at an insolvency scenario'.[15] As explained by Treasury at the public hearing, the proposal essentially uncouples members' and creditors' meetings:

> We have sought to address this issue of making it easier to put a company into creditors' voluntary liquidation through a slightly different mechanism, which has been to uncouple the members meeting and the creditors meeting. Currently the creditors meeting and the members meeting must be held on the same day, and there must be a certain notice period before the creditors meeting. Uncoupling the process…allows directors to hold a members meeting on the same day…which will allow them to put the company into CVL that day and to then have a creditors meeting several days later.[16]

2.16 The IPAA submission argued that although the proposed amendments are a significant improvement over the existing process, its preferred position is that directors be able to appoint a liquidator by resolution at a meeting of directors, as is currently the means by which directors appoint a Voluntary Administrator.[17]

2.17 While the committee accepts that the proposed amendments are a significant improvement on the existing process, it is disappointed with the Government's continuing rejection of recommendation 54. It believes that more can be done to further modify and simplify the CVL process and the Government should give further consideration to the refinements suggested by the IPAA.

Recommendation 2

2.18 The committee recommends that in the light of support for recommendation 54 from the major insolvency and accounting bodies, the Government reconsider its position in relation to recommendation 54. In particular, the committee recommends that Treasury examine ways to modify and simplify the CVL procedure to enable a company to be placed into liquidation immediately to maximise recoveries for the benefit of creditors.

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15 Mrs Kim Arnold, Technical Director, Insolvency Practitioners Association of Australia, *Committee Hansard*, 5 March 2007, p.38

16 Mr Matthew Brine, Manager, Government and Insolvency Unit, Corporations and Financial Services Division, Markets Group, The Treasury, *Committee Hansard*, 5 March 2007, p.8

17 Insolvency Practitioners Association of Australia, *Submission 3,* p.4

Role of administrators

Administrators' casting vote

2.19 The committee is concerned that the Government continues to reject recommendation 3 – that an administrator should be prohibited from using a casting vote in a resolution concerning his or her replacement.[18] The Government response stated that the current practice is sufficiently regulated by the requirement that it must be exercised in what the administrator perceives to be the overall best interests of the company, and the right of creditors to challenge the exercise of the vote in court. Treasury expanded on this response by noting, in part, that a prohibition may be ineffective on the basis that the administrator can effectively confirm their own appointment by simply refraining from using their casting vote to affect their removal.[19]

2.20 The committee believes that the issue of conflicts of interest and how to avoid them is central to all business dealings. In this context, the power of an administrator to exercise a casting vote may call into question his or her independence and give rise to an apparent conflict of interest. The accounting bodies agreed with the committee. The joint ICAA/CPA Australia submission noted that recommendation 3 '…gives underpinning to independence as one of the cornerstones of external administration'.[20]

2.21 The committee does not believe the Government response adequately addressed concerns that have been raised about the independence of administrators, or that Treasury's response is an argument against the committee's recommendation. The submission from Treasury demonstrates that the Government has not consulted with industry to find an alternative voting procedure for administrators that would underpin their independence and satisfy the committee's intention that conflicts of interest be avoided.

2.22 The committee believes strongly that this issue requires the attention of the Government and industry stakeholders to find an innovative solution. It is the committee's view that the Government should be willing to consult with industry to reach a compromise position which neither mandates a prohibition on the use of a casting vote, as proposed in recommendation 3, nor mandates discretion in all circumstances, which the Government supports.

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18 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.40

19 The Treasury, *Submission 10*, p.2

20 The Institute of Chartered Accountants in Australia and CPA Australia, *Submission 12*, p.1

Recommendation 3

2.23 The committee recommends that the Government and industry stakeholders review the right of administrators to use a casting vote in relation to his or her removal and develop an alternative voting mechanism that would satisfy the committee's intent on avoiding conflicts of interest.

Prohibitions on terminations of contract

2.24 During its previous inquiry into corporate insolvency laws the committee considered whether clauses entered in to by companies that give the other party to the contract the right to terminate the contract 'by the mere fact of the other party's insolvency' – so-called 'ipso facto' clauses – should be removed. Such clauses permit termination of an agreement simply because of the other party's financial difficulties. Committee recommendation 55 states in part that:

> …the law be amended so as to permit administrators to apply to a court for an order that a party to a contract may not terminate the contract by virtue of entry by a company into voluntary administration. The court should be satisfied that the contracting party's interests will be adequately protected.[21]

2.25 The committee remains of the view that a blanket moratorium of the kind then proposed by the IPAA might represent an erosion of the principle of freedom of contract and introduce considerable complexity and extra costs into commercial dealings. This is why the committee qualified its recommendation by proposing that a court must be satisfied that the contracting party's interests will be adequately protected.

2.26 The Government rejected the recommendation because it held the view that a prohibition on the enforceability of 'ipso facto' clauses would erode the freedom of contract, restrict the capacity of creditors to manage risks, introduce a high level of complexity to the law and increase the costs of voluntary administrations where an application is made to the courts.

2.27 The committee does not believe the Government's response or additional comments from Treasury take into consideration the important safeguard built into the recommendation. The committee notes the IPAA's view that by recommending the involvement of a court in the process '…the committee struck a good balance between a straight-out moratorium and ensuring freedom of contract between the parties'.[22] The IPAA submission to Treasury endorsed the committee's recommendation and requested that the Government reconsider its position in relation to this issue. It noted that:

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21 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.55

22 Mrs Kim Arnold, Technical Director, Insolvency Practitioners Association of Australia, *Committee Hansard*, 5 March 2007, p.43

> …based on the experience of [IPAA] members, particularly in larger Voluntary Administrations, that to achieve the objectives of Part 5.3A, an Administrator needs to have the right to continue with contracts – not to have a decision made by the other party to the contract. The other party to the contract would be protected by the fact that the matter must be dealt with by the Court and the requirements that the Court be satisfied that the contracting party's interests will be adequately protected.[23]

2.28 The Treasury submission referred only to circumstances where companies have incentives to continue to trade with enterprises in external administration: 'Such commercial decisions should be left to individual companies to determine in light of their, and their counterparty's, circumstances'.[24] However, during the public hearing the IPAA rightly pointed out that Treasury's argument is not clear cut:

> [Treasury's] statement that a company would be financially advantaged by continuing—that can be true and it can be untrue. There may be commercial advantages in terminating the contract which destroys value for the debtor company, and they are the instances in which we think the ipso facto clauses would preserve value for those other interested stakeholders.[25]

2.29 The committee agrees with the IPAA that there are many examples, especially in the telecommunications industry, where a contract with a company might be the only actual valuable asset and its termination could result in a total erosion of the asset base of the insolvent company.[26]

2.30 The Law Council drew the committee's attention to an important distinction between a breach of contract when a voluntary administrator is appointed and a breach which occurs before and after that appointment. It was pointed out that while companies should be entitled to terminate contracts pre and post appointment, the situation when appointment takes place is fundamentally different:

> What is happening and what is of concern is that the mere appointment of the administrator gives rise to the right to terminate without actually giving the company the opportunity, consistent with part 5.3A objects, to continue to trade forward in the future, albeit under the auspices of the administrator. As long as that contract is continuing to perform, why should that contractor, where it is so fundamental, be entitled to simply say, 'Well, it's

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23 Institute of Insolvency Practitioners Association of Australia, Submission to Treasury, Exposure Draft, Corporations Amendment (Insolvency) Bill 2007, paragraph 21.4

24 The Treasury, *Submission 10*, p.12

25 Mr John Melluish, Insolvency Practitioners Association of Australia, *Committee Hansard*, 5 March 2007, p.43

26 Mrs Kim Arnold, Technical Director, Insolvency Practitioners Association of Australia, *Committee Hansard*, 5 March 2007, p.43

> too bad; you've appointed a voluntary administrator, I'm terminating my contract,' because it is so contrary to the whole of the objects of part 5.3A.[27]

2.31 The committee agrees with the Law Council's concern because it appears the existing process is contrary to Part 5.3A, and also because the appointment of an administrator is designed to remediate a problem. Furthermore, administrators unlike receivers are specifically charged with finding a viable business outcome. The committee believes that the Government and Treasury have overlooked this important distinction. It believes further that a prohibition on ipso facto clauses agreed to by a Court should not apply to existing contracts; it should only be prospective in its effect.

Recommendation 4

2.32 The committee recommends that in the light of evidence from industry stakeholders, the Government reconsider its position in relation to recommendation 55. The committee recommends that the Government pay particular attention to the operation of 'ipso facto' clauses.

Role of directors

Reconstructing financial records

2.33 In making its recommendation 10 to permit an administrator or a liquidator to recover from directors who have failed to ensure that company records are complete and up-to-date the cost of reconstructing those records, the committee noted in its *stocktake* report the clear obligation of directors to keep financial records:

> …it seems only fair and reasonable that directors who do not keep proper records should be the ones held accountable for the costs incurred by an administrator in having to reconstruct financial records because of the directors' failure. The Committee considers that such costs should not be borne by the creditors.[28]

2.34 The recommendation was rejected by the Government on the grounds it would create uncertainty both as to the liability of individual, non-culpable directors and the quantum of any potential liability.[29] Treasury's submission and its evidence at the public hearing enlarged on the Government response. Treasury pointed out that any new obligation on directors would affect over 1.5 million companies and have a significant potential impact on corporate governance norms. It would alter the current balance between promoting market integrity and not discouraging entrepreneurship, giving rise to several practical difficulties:

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27 Mr John Proudman, National Chair, Insolvency and Reconstruction Committee, Business Law Section, Law Council of Australia, *Committee Hansard*, 5 March 2007, p.56

28 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.55

29 The Government's position is supported by Chartered Secretaries Australia, *Submission 4*, p.2

- it is not clear how an administrator would reconstruct records that are missing or do not exist;
- the cost of reconstructing records could be significant; and
- directors not involved in maintaining or updating financial records would be exposed to new liabilities.[30]

2.35 While acknowledging the concerns raised by Treasury, the committee does not believe the Government has given sufficient weight to its recommendation or considered the views of the Law Council of Australia, IPAA, CPA Australia and the ICAA. National Chair of the Law Council's Insolvency and Reconstruction Committee, Mr David Proudman, told the committee at its hearing that the Council strongly supported recommendation 10:

> I share the same concerns that the IPAA have…It certainly seems to me and I think to the Law Council generally that when you become a director of a company you are thereupon obligated to do certain things…It seems inappropriate that you should be able to…get away with not doing something as fundamental as maintaining good books and records of a company…particularly in light of the fact…that a very large proportion of insolvencies arise as a consequence of not having proper books and records. So I am very supportive of that view and I think it would be a significant deterrent…that will send a very clear message to a lot of people.[31]

2.36 The IPPA submission argued that implementation of the committee's recommendation would assist liquidators with their investigations of failed companies and the identification of phoenix activities. The committee accepts the IPAA's view that it is very difficult for insolvency practitioners to do their work when there are no books or records to begin with. National President of the IPAA, Mr John Melluish, expressed a view from the perspective of a practitioner:

> As a practitioner, the majority of circumstances where there is a lack of books and records do not relate to those books and records being written up properly. It is the provision of the source documentation to begin with…So in terms of the lack of books and records…assessing the cost of writing them up would not be a complete answer to the problem. But it is a recommendation that we would support in that we think greater responsibility should be placed on those directors who fail to adhere to their obligations.[32]

2.37 The ICAA/CPA Australia submission supported the committee's recommendation on the grounds that it would give added weight to the gravity of any

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30 Mr Matthew Brine, Manager, Government and Insolvency Unit, Corporations and Financial Services Division, Markets Group, The Treasury, *Committee Hansard*, 5 March 2007, p.9

31 Mr David Proudman, National Chair, Insolvency and Reconstruction Committee, Business Law Section, Law Council of Australia, *Committee Hansard*, 5 March 2007, p.55

32 *Committee Hansard*, 5 March 2007, p.40

breach of section 286 of the Corporations Act and assist liquidators in the conduct of administrations.[33] Policy Advisor for CPA, Mr John Anthony, told the committee that while striking the right balance in relation to directors' duties is difficult:

> From the accounting profession's perspective, one of the areas of vital interest to us is compliance with section 286. The stronger the message can be that directors take the key responsibility for ensuring that accounts are kept and maintained, the better the chances for quality outcomes in insolvency administration. So it is conceded that there are particular issues and complexities associated with recovering accounting records that may have been disposed of, destroyed or hidden. Nonetheless, it is a significant message about accounting practice and to directors in particular that there is a key responsibility there.[34]

2.38 The committee notes that under current law directors are required to keep proper accounts which would enable liquidators to discharge their duties. However, the current penalty provisions for breach of section 286 of the Corporations Act do not provide a sufficient deterrent. The IPAA provided an example of what currently happens in practice when a director fails to provide a liquidator with any books or records:

> A company goes into official liquidation and the directors may know that they owe that company some money, by way of a directors' loan account, or there have been transactions where that would ultimately cost them money. They go to the liquidator and say, 'No, I do not have any records; they have been tossed in the bin.' The liquidator would then report that to ASIC and the liquidator assistance unit would then take the matter off to a local court. The result of that process would be that they could be fined between $500 and $2,000. So, in terms of an out for them, it is much easier to take the fine of $500 than bother giving the records and exposing themselves to a larger claim.[35]

2.39 To the extent that the current penalties do not provide a sufficient deterrent, the committee is of the view that the proposal contained in recommendation 10 provides an important added incentive for directors to comply with the existing law. The committee also believes there should be greater penalties for directors who fail to keep proper financial records.

Recommendation 5

2.40 The committee recommends that the penalty provisions for breach of section 286 of the Corporations Act be significantly increased to act as an effective deterrent for directors to ensure that proper financial records are kept. The committee recommends that Treasury develop an appropriate scale of penalties which apply to companies of different sizes.

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33 The Institute of Chartered Accountants in Australia and CPA Australia, *Submission 12*, p.2

34 CPA Australia, *Committee Hansard*, 5 March 2007, p.28

35 Mr John Melluish, National President, IPAA, *Committee Hansard*, 5 March 2007, p.41

2.41 The committee does not believe the Government has considered practical alternatives that reinforce the committee's original recommendation and address concerns raised by Treasury. While existing Government initiatives such as the Assetless Administration Funds, stricter regulation of insolvency practitioners and ASIC's enhanced powers have generally worked to discourage corporate misconduct, the committee does not believe the Government has struck the right balance on this issue. There remains too much room for directors engaged in wrongdoing to evade the law. Phoenix companies, for example, invariably involve directors closely involved in the maintenance or non-maintenance of company records. This remains an area of concern for the committee.

2.42 To highlight this point, Treasury responded cautiously to two alternatives raised by the committee during the hearing that would satisfy its recommendation and probably allay Treasury's concerns. The first alternative involves devising a mechanism to identify certain classes of directors, such as executive directors, with hands-on involvement in the control of a company, its operation and book keeping to whom any new obligation would apply. This approach focuses on the conduct of certain classes of directors which, in Treasury's view, would be a departure from the general principle applying to directors' duties in sections 180 and 184 of the Corporations Act. However, Treasury conceded that legally speaking, '…it would be technically possible to craft a provision that talked about directors who feel that they are the only company officer or the only shareholder…'[36]

2.43 The second and more targeted alternative would remove from the liquidator or administrator the decision to recover from directors the cost of reconstructing a company's financial records and place it in the hands of an objective third party, either ASIC or the courts. The committee believes that under this half-way position a liquidator or administrator would make an application to ASIC or a court for a process of reconstructing company records and recovering costs. The committee's preference is for an arms-length administrative process involving a regulatory body such as ASIC. This would avoid the cost and time delays which are likely in any court proceedings. Treasury conceded that any process with appropriate safeguards '…would have some merit'.[37]

2.44 However, CPA Australia shared the concerns expressed by Treasury at the hearing about the potential arbitrariness of introducing into the law a differential in treatment based on either a class of behaviour or size of company. And while the IPAA argued that the introduction of an administrative process has merit, it raised some concerns with such a proposal: the cost involved in making an application to ASIC and the level of evidence that the external practitioner may be required to provide; whether ASIC would be adequately funded to provide this service given its

36 Mr Matthew Brine, Manager, Government and Insolvency Unit, Corporations and Financial Services Division, Markets Group, The Treasury, *Committee Hansard*, 5 March 2007, p.10

37 ibid., p.11

many competing regulatory and compliance obligations; and the need to complement such a process with increased penalties for breaches of section 286.[38]

2.45 In relation to Treasury's concern that development of the law as proposed in recommendation 10 has the potential to unduly penalise innocent, minor or inadvertent mistakes, the committee notes that CPA Australia in answers to question on notice drew attention to s588E(6) as a possible guide to development in this area. This section provides relief from the presumption of insolvency where the contravention of s286 is of a minor or technical nature.[39]

2.46 In the light of the strong support for recommendation 10 from the Law Council of Australia, IPAA, CPA Australia and the ICAA, the committee believes that the Government, as a first step, reconsider its position in relation to this issue.

Recommendation 6

2.47 The committee recommends that Treasury give consideration to alternative administrative processes (discussed in paragraphs 2.41 and 2.42) that would permit an administrator or liquidator to recover from certain classes of directors who fail to ensure that company records are complete and up-to-date, the costs and expense of reconstructing company records.

Disqualification provisions

2.48 Section 206F of the Corporations Act allows ASIC, independently of the courts, to disqualify a person from managing corporations for up to five years. The committee believes that sections 206D and 206F of the Corporations Act may impose too many legislative hurdles and preconditions for their effective operation. During its previous inquiry the committee noted that section 206F is a rarely used provision. In evidence provided in relation to a previous statutory oversight hearing, ASIC advised that it had not finalised any disqualifications under section 206F in the year to 30 June 2003. There were two disqualifications in July 2003 and another in August 2003.

2.49 The committee in its 2004 *stocktake* report argued that sections 206D and 206F be cast in simpler terms and recommended that the law permit a court, or ASIC in its discretion, to disqualify a person from being a director where essentially two conditions are met: the person is or has been a director of a company which has failed and the person's conduct as a director of the company makes him or her unfit to be involved in its management.[40] The Government rejected the recommendation on the grounds that unlawful phoenix activity typically involves two or more corporate failures.

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38 Insolvency Practitioners Association of Australia, answers to question on notice, 20 March 2007

39 CPA Australia, answer to question on notice, 21 March 2007

40 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, pp.144-45

2.50 The submission from the Australian National Audit Office (ANAO) drew the committee's attention to its audit of ASIC's processes for receiving and referring for investigation statutory reports of suspected breaches of the Corporations Act, which was tabled on 24 January 2007. The report was completed in response to committee recommendation 39 that the ANAO conduct a performance audit of ASIC's processes in receiving and investigating statutory reports. The audit report found that ASIC's use of its powers under section 206F to disqualify persons from managing corporations has declined markedly over time, from a peak of 211 disqualifications in 1987-88 to a low of nine in 2002-03.[41]

2.51 The audit report also stressed that ASIC's power under section 206F is intended to be protective and not punitive in nature: 'That is, the reason behind the disqualification power is not to punish the person involved, but to protect the public from the conduct of a person who has demonstrated an inability to manage corporations'.[42] The committee notes that to assist ASIC make greater use of its disqualification power, the draft bill contains a provision which explicitly states that disqualifications are not to be taken to be by way of a penalty.

2.52 The ICAA/CPA Australia submission tentatively agreed with the Government's response on the grounds that:

> It may be appropriate to allow some lapse in time to assess the effectiveness of the strengthening of ss 206D and 206F, along with the Assetless Administration Fund initiative, before initiating further change to the law. Clearly corporate misconduct and the abuse of the corporate form require [a] prompt and significant regulatory responses. Balance is nonetheless required to ensure that individuals are not unduly discouraged from taking on directorships and engaging in legitimate commercial risk.[43]

2.53 It is not clear to the committee how the 'balance' referred to in the submission will be achieved, or how the effectiveness of government initiatives to strengthen the assetless administration fund is to be measured and reported on. While the committee welcomes measures that have been taken by the Government to deter fraudulent phoenix activity, it believes that further changes to the law are necessary to permit ASIC or a court to take swift and significant action in the event of corporate misconduct which may or may not relate to phoenix activity.

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41 Australian National Audit Office, *ASIC's Processes for Receiving and Referring for Investigation Statutory Breaches Reports of Suspected Breaches of the Corporations Act 2001*, Audit Report No. 18 2006-2007, p.79

42 ibid., p.81

43 The Institute of Chartered Accountants in Australia and CPA Australia, *Submission 12*, p.4

Recommendation 7

2.54 The committee recommends that the draft bill be amended to reflect committee recommendation 31. The committee further recommends that ASIC benchmark the effectiveness of programs to combat fraudulent phoenix companies and other abuses of the corporate form, and make its findings publicly available.

Treatment of employee entitlements

Superannuation entitlements

2.55 The committee believes that the protection of employee entitlements in the event of employer insolvency remains an important public policy issue. It notes that an important element of Government arrangements for the protection of employee entitlements is the General Employee Entitlements and Redundancy Scheme (GEERS), which protects the entitlements of employees whose employment has been terminated due to their employer's insolvency. In its *stocktake* report, the committee expressed the view that GEERS should be extended to cover superannuation entitlements, even though its deliberations focused on measures to ensure superannuation contributions are made and protected rather than recovered after a company fails.[44]

2.56 Some of the proposals originally included in the Government's insolvency package relating to GEERS, notably an expansion of the range of entitlements available to employees under the GEERS scheme, are already in place. An additional $62 million has been allocated over four years for a range of enhancements to GEERS, which applies to insolvencies that occurred on or after 1 November 2005. A further extension to GEERS that doubles the amount of unpaid redundancy pay under the scheme from 8 weeks to a maximum of 16 weeks was announced by the Minister for Employment and Workplace Relations in August 2006.

2.57 The committee notes that the draft bill includes a provision to equate unpaid superannuation guarantee obligations with the high priority given to superannuation in the event of insolvency. This goes some way to addressing the committee's recommendation 47 that the Government clarify the priority afforded superannuation contributions required to be made after the 'relevant date' of an external administration.[45] The Treasury submission conceded that under the current law there is some uncertainty about the standing of the Superannuation Guarantee Charge (SGC) in different forms of insolvency trading:

> The proposed measures [in the Exposure Draft] will clarify the status and priority of the [SGC] in insolvency. They will give SGC the highest

44 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, Executive Summary, p.xxv

45 ibid., p.197

> priority, along with wages and superannuation, that employee entitlements enjoy under the law. SGC will enjoy a superior priority over other unsecured creditors such as suppliers, subcontractors, customers and creditors whose debts are secured by a floating charge. These measures will significantly improve the prospect of recovery of outstanding superannuation obligations in the event of employer insolvency.[46]

2.58 While the committee welcomes the enhancements that have been made to GEERS, it remains concerned that some employees who are entitled to recover money under the scheme, including superannuation entitlements, are unable to do so because the company did not keep any paperwork. This results in an unsatisfactory situation where the onus is placed on individuals to search through personal records to find time sheets, tax returns and other financial documents in order to recreate a paper trail after the event. The committee notes that while approximately 25,000 of 1.5 million companies are required by law to provide ASIC with annual accounts which are audited for the public record, it is difficult, if not impossible, for ASIC to monitor on a real-time basis the obligations of the remaining directors.

2.59 ASIC told the committee about the work conducted through its National Insolvency Coordination Unit, which is designed to address a problem before it results in the collapse of a company. According to Executive Director, Mr Malcolm Rodgers: '…we have visited in excess of 1,600 companies that we had some reason to imagine might need our advice because there might be a looming insolvency or a failure to meet their obligations'.[47] Yet Mr Rodgers conceded that '…even targeting those is fairly difficult' and they represent '…a relatively small number in a very large population'.[48]

2.60 This situation lends further weight to the committee's support for a more targeted approach that would capture circumstances involving directors with a history of bad corporate behaviour. The committee strongly supports any practical and cost-effective measures to improve record keeping and the level of information that is provided to administrators.

Recommendation 8

2.61 The committee recommends that the Government compile data on the incidence of employees who are unable to receive their entitlements under GEERS due to a lack of company records. The committee further recommends that the Government examine any practical and cost-effective measures, including minimum standards of training, to assist relevant directors and company officers in maintaining appropriate and up-to-date company records and to ensure employee entitlements under GEERS are met.

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46 The Treasury, *Submission 10*, p.11

47 Mr Malcolm Rodgers, Australian Securities and Investments Commission, *Committee Hansard*, 5 March 2007, p.19

48 ibid.

2.62 The committee remains committed to recommendation 44 that the Government explore the various measures proposed for safeguarding employee entitlements such as insurance schemes or trust funds giving particular attention to the costs and benefits involved in the schemes.[49] However, it notes that while the Government supported this recommendation 'in principle' it appears no action has been taken to implement it. The Government response stated that the Government '…remains willing to examine and explore other measures which might enhance the operation of the [GEERS] scheme or provide employees with similar levels of protection'. The submission from Treasury added that a review of GEERS is scheduled to be conducted in the 2008-09 Budget context and that the Department of Employment and Workplace Relations will be considering previous findings and international examples of protecting employee entitlements in the event of employer insolvency.[50]

Recommendation 9

2.63 The committee recommends that any proposed review of GEERS specifically include an analysis of the costs and benefits of alternative measures for safeguarding employee entitlements such as insurance schemes and trust funds.

Empirical research and review processes

Assetless companies

2.64 The phenomenon of assetless companies and their association with phoenix activity was one of the major issues examined by the committee in its 2004 *stocktake* report. Evidence to the committee then showed that the incidence of companies taking deliberate actions to avoid paying creditors, especially employees, their entitlements was significant. The committee noted the lack of empirical data on the incidence or effects of assetless companies. It noted further that ASIC's analysis of the 6,176 statutory reports from external administrators in 2002-03 provided limited information about the incidence and impact of assetless companies. One of two recommendations made by the committee on this issue was that ASIC immediately begin to collate statistics on insolvent assetless companies and publish such figures on a triennial basis together with an analysis (recommendation 30).[51]

2.65 Creation of an Assetless Administration fund by the Government in October 2005, which provided funding to ASIC of $23 million over four years to establish the fund and undertake follow-up work, is an important measure to enable liquidators in the first instance to investigate and prepare supplementary reports when proceedings

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49 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, Executive Summary, p.190

50 The Treasury, *Submission 10*, p.10

51 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.129

banning directors are considered appropriate. The submission from ASIC provided details of its administration of the fund and recent outcomes. Since the fund was launched:

- ASIC has approved 164 applications for funding of investigations and reports on potential director banning matters;
- liquidators' reports funded by the fund have resulted in the banning of 30 directors engaged in misconduct associated with company failures and repeat phoenix activity;
- ASIC currently has 56 potential banning matters in progress using information in funded liquidator reports; and
- ASIC has approved 10 applications for funding of reports on potential breaches of the Corporations Act that may warrant civil penalty proceedings or criminal prosecution.[52]

2.66 ASIC's response to recommendation 30 in its submission stated: 'ASIC notes that it is compiling statistics from electronically lodged statutory reports in the format of Schedule B to ASIC's Practice Note *50 External administrators: reporting and lodging* for the 2004/2005 and 2005/2006 financial years'.[53] When asked by the committee to explain how this response relates specifically to assetless companies, Mr Rodgers, Executive Director, stated:

> What we did some years ago was to invite external administrators to supply us not only with the information that [the Corporations] act requires but with a fair bit more information at the beginning of the administration process than the law strictly requires. That is something the profession has embraced and accepted. The data coming to us electronically goes to our ability to create a snapshot not only of what is occurring in a particular administration and the circumstances of a particular administration. It enables us to collate that information and reflect more generally on the pattern that is emerging with external administrations more generally. One of the questions we ask is about the size of the losses and the assets that are or may be available.[54]

2.67 Notwithstanding the useful work undertaken by ASIC in this area, the committee remains concerned about the lack of available data on the nature and extent of assetless companies and the Government's continued rejection of the committee's proposal, as reflected in recommendation 29, that the Government commission an empirical study of assetless companies.[55] The Government response in October 2005

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52 Australian Securities and Investments Commission, *Submission 7*, p.5

53 ibid., p.8

54 Mr Malcolm Rodgers, Australian Securities and Investments Commission, *Committee Hansard*, 5 March 2007, p.19

55 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, June 2004, p.129

asserted that an empirical study is unnecessary because the opportunity to obtain 'improved information' will arise from establishment of the Assetless Administration Fund and enhanced enforcement activity in this area. The committee, however, notes that Treasury provided a different answer when questioned about recommendation 29 at the public hearing, which referred only to budgetary priorities and activities undertaken by ASIC:

> Perhaps the point is not that we are opposed to a study but rather that, in making decisions about which funding matters to prioritise, the government has not made a decision to fund this initiative at this point in time. However in that context I would note that ASIC is getting more information about assetless administration through the administration of its fund and its liaison with liquidators…[56]

2.68 Currently, ASIC maintains a register of disqualified directors, but the register applies only to directors who are disqualified as a result of action taken by ASIC. It does not include all directors who are disqualified under the law. Mr Rodgers told the committee that while there is logic in the proposal to expand the public register of corporations to include information about the conduct of directors, it raised significant and interesting public policy issues. ASIC stated that it was not in a position to go down this path of its own accord. The committee agrees, and notes further that this is first and foremost a policy matter for Government.

2.69 In the light of responses from Treasury and ASIC, the committee believes a more concerted and cooperative policy effort is required by the Government to facilitate the centralisation of reliable data on the nature, effects and extent of insolvent assetless companies, in addition to any information that arises from the operation of the Assetless Administration Fund. There is currently no central register of people with a history of bankruptcy or phoenix company activity who have failed to lodge tax statements which would provide liquidators with useful and reliable historical data about wrongful behaviour and particular circumstances. The committee does not believe the practical and policy barriers to setting up a central register are insurmountable.

Recommendation 10

2.70 The committee recommends that Treasury and ASIC jointly examine ways to devise a formal reporting mechanism that would require ASIC to automatically provide liquidators with background information about officers convicted of a serious criminal offence or an offence involving fraud or dishonesty in the operation of a company.

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56 Mr Matthew Brine, Manager, Government and Insolvency Unit, Corporations and Financial Services Division, Markets Group, The Treasury, *Committee Hansard* , 5 March 2007, p.12

Conclusion

2.71 The committee believes that evidence received during the inquiry has justified its decision to revisit a number of recommendations from its 2004 *stocktake* report. In particular, the committee found either in principle or strong support for most of the recommendations rejected by the Government from the accounting bodies, the IPAA and the Law Council. The opportunity to explore a number of issues with stakeholders at a hearing resulted in some useful suggestions and proposals which justify the Government and Treasury revisiting a number of the committee's recommendations.

2.72 The committee notes that evidence from the main insolvency and accounting bodies have endorsed the draft bill as reflecting much needed reforms, and expressed strongly the view that believe there are no matters of such significance raised by the bill that would justify any delay to its introduction and passage through the Parliament this year. The committee agrees with this view, and strongly supports the introduction and passage of the bill through the Parliament, if possible before the end of the financial year.

2.73 Officials from Treasury confirmed at the public hearing that additional amending legislation in relation to insolvency might be required as early as 2008 to address new developments, such as the *Sons of Gwalia* High Court ruling and the Model Law on Cross-Border Insolvency. The committee will maintain a watchful eye over any further legislative responses from the Government to these and other reform proposals to insolvency laws. The committee is confident there will be other opportunities to inquire into matters not considered as part of this inquiry.

Senator Grant Chapman
Chairman