Comments on the Exposure Draft – Corporations Amendment (Insolvency) Bill 2007

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We submit the following further comments in relation to the proposed Bill, specifically in relation to the Government's response to Recommendation 43 of the Parliamentary Joint Committee on Corporations and Financial Services *Corporate Insolvency Laws: a Stocktake* – the rights of creditors generally.[2]

We believe that the draft Insolvency Bill provides desirable changes in the legislation with respect to creditors such as employees and those deemed unable to sufficiently protect their interests, such as tortfeasors. Such creditor protection might be justified on the basis of those particular creditors as being third-parties to business transactions generally who cannot diversify to reduce their risks. However with respect to trade creditors, generally unsecured, we do not support the need for CAMAC to review business practices around non-payment of these stakeholders.

Unsecured trade creditors have significantly greater legislative protection since the decision in *Salomon v Salomon*[3] where Lord Macnaghten noted that the "great scandal" that ordinary creditors did not rank ahead of floating charge holders.[4] More realistically however, his fellow judge Lord Watson noted that the unpaid creditors in the instant case "if they had thought to avail themselves of the means of protecting their interests… could have informed themselves"[5] and herein lays the difference in opinion.

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[2] Note that this submission draws substantially from the PhD of Dr David Morrison, notably Chapters 1 and 6 and subsequent publications including Morrison DS, *The Australian Insolvent Trading Prohibition – why does it exist?* International Insolvency Review, 2002; Morrison DS, *An Historical and Economic Overview of the Insolvent Trading Provision in the Corporations Law*, International Trade & Business Law Annual, Volume VII, April 2002, pages 91-129; Morrison DS, *The Economic Necessity for the Australian Insolvent Trading Prohibition*, International Insolvency Review, 2003.

[3] [1897] AC 22.

[4] [1897] AC 22 at 53.

[5] [1897] AC 22 at 40.

The key point made by Lord Watson is that the relevant company legislation ought to ensure that members of the public understand that there is a risk of not being paid where a company is not thriving.[6]

We think most people, including those not engaging directly in business transactions, understand this notwithstanding that, where possible, they will seek to protect themselves against this by having greater rights to recover.

As early as the English Loreburn Committee[7], it was observed that the majority of companies were honestly formed and conducted and it is submitted that this is still the case today. The current legislature will be set up for a spectacular failure if it is required to provide laws for activities that include those referred to in Recommendation 43, namely:

> "… in light of evidence suggesting that some corporations deliberately structure their business to avoid paying their full entitlements to employees *and more generally unsecured creditors* (*emphasis* added), the Committee recommends that the review look beyond the effectiveness of the Act and consider, and offer advice on, possible reforms that would deter this type of behaviour."

If structuring, avoidance of legal obligations and more specifically phoenix company behaviour, is in fact a market place reality, then it is fair to observe that it remains largely undetected. Alternatively (and in the absence of any empirical data to support the proposition) such activity constitutes a relatively small proportion of total market place transactions and like many other undesirable societal behaviours must be recognised as part and parcel of a relatively open economy's attempt to replicate a free enterprise environment.[8]

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[6] [1897] AC 22 at 40.
[7] Report of the Company Law Amendment Committee, Cd 3052, London, HMSO, February 1905.
[8] Anderson H, Creditors' rights of recovery: economic theory, corporate jurisprudence and the role of fairness, [2006] Melbourne University Law Review 1; Morrison DS, The addition of uncommercial transactions to s 588G and its implications for phoenix activities, Insolvency Law Journal, Volume 10, December 2002, pages 229-238.

The Loreburn Committee's recommendation in respect of undesirable market activity in 1905 is apposite in the current circumstances, namely adequate disclosure of financial information.[9] It was the Greene Committee[10] (following Loreburn) that started the trend towards creditor protection based on anecdotal rather than empirical evidence to support the assertion that such protection was necessary, a trend followed by Australian law makers on similarly unsubstantiated grounds.[11]

Trade creditors have every opportunity to make enquiries on their own behalf in supplying goods and services and it is extraordinarily unfair to ask the Australian taxpayer to further fund the making of bad bargains by any creditor.

If trade creditors make bad bargains, then the consequence of doing so must rest with them and their enterprise. Creditors are already looked upon by the Australian legislature favourably, and one might suggest somewhat uncharitably as a special interest group – when in fact, harking back to the life and times of Mr Salomon up until today, creditors are also always owners of capital and debtors and therefore perfectly understand the nature of a bargain and the risks that some transactions will not be profitable. Whether the transaction has an element of misrepresentation or fraud within it or not, this is a risk of doing business and one that is well known to all participants.

If a business feels that they need not make inquiries from those that they provide credit to, nor indeed to learn from errors that they make as a result of a lack of diligence or where business feels that the costs of due inquiry outweigh the benefits, then such an attitude may be countered by simply engaging in a diversified portfolio investment approach to their business – namely to have lots of debtors in order to spread the risk.[12]

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[9] Report of the Company Law Amendment Committee, Cd 3052, London, HMSO, February 1905 at 13.
[10] Company Law Amendment Committee Report 1925-1926, Cmd 2657, London HMSO, 1926 at 5.
[11] Most notably by the Harmer Committee, The Law Reform Commission, Report No 45, General Insolvency Inquiry ALRC 45, AGPS, Canberra, 1988.
[12] Morrison DS, Chapter 6 "Assessing Insolvent Trading", PhD thesis, The University of Queensland, 2001 based on empirically proven financial economics research relating to investments. See for example Fama EF, "Efficient capital markets: A review of theory and empirical work"; (1970) 25 *Journal of Finance* 383.

The key point here is that there are realistic strategies that businesses need to adopt before seeking further government assistance and protection if we want to strengthen economic activity by means of encouraging entrepreneurship and ensuring only viable business operations survive. There is plenty of help already for creditors because Australia is a pro-creditor business environment through the regulated insolvency practitioner market, strong insolvent trading provisions and an active regulator in ASIC.

The government's response to Recommendation 43 is apposite here in pointing out that there are already reforms in place around director duties that strengthen creditor protection.[13] Indeed there is plenty of law, what is needed is effective enforcement of same – but certainly no more protection until we properly understand whether in fact there is a problem supported by verifiable empirically-based evidence and demonstration that law reform will remedy the inadequacy of the existing law. That is it is necessary to give the proposed reforms a chance to work prior to engaging in yet further changes. The provisions in the draft proposal should be allowed to bed down prior to considering what else might be done.

End of submission.

[13] "The Government has announced an integrated set of proposals to improve the operation of Australia's insolvency laws, including a range of initiatives intended to complement the general body of rules concerning the duties of company officers and to strengthen creditor protections." http://www.aph.gov.au/senate/committee/corporations_ctte/insolvency/index.htm downloaded 26 February 2007.