ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

26 August 2014

Mr David Murray AO
Chair
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

By email: fsi@fsi.gov.au

Dear Mr Murray

Financial System Inquiry Interim Report

The Australian Restructuring Insolvency and Turnaround Association ("ARITA") represents insolvency practitioners and other professionals who specialise in the field of insolvency, restructuring and turnaround. We cover more than 2,200 members including accountants, lawyers, bankers, credit managers, academics and other professionals with an interest in insolvency and restructuring. ARITA's mission is to support insolvency and recovery professionals in their quest to restore the economic value of underperforming businesses and to assist financially challenged individuals. We deliver this through the provision of innovative training and education, upholding world class ethical and professional standards, partnering with government and promoting the ideals of the profession to the public at large. 76% of all registered liquidators and 86% of all registered trustees in bankruptcy are members of ARITA.

Our members have dealt with many of the significant external administration issues raised in the Inquiry's Interim Report ("the Interim Report"), including the winding up of managed investments schemes, insurers, and financiers, and small to medium enterprise ("SME") businesses. ARITA itself has made many submissions to government on issues raised in the Interim Report (refer Annexure A for a list of relevant submissions). We are also pursuing our own thought leadership in this area by way of proposing an insolvency framework with recommendations to improve the overall operation of the corporate insolvency regime in Australia.

Our submission largely focuses on responding to Chapter 3 of the Interim Report - *Funding – External Administration* - with some commentary on other areas of the Report that touch upon the insolvency and reconstruction of entities in financial distress. These issues include banks (ADIs), the use of technology, managed investment schemes, and the need for general reform of insolvency legislation.

1 Executive Summary

ARITA will, in the coming weeks, deliver a comprehensive thought leadership project which will recommend improvements to the operation of Australia's corporate insolvency regime including the need for earlier intervention in distressed businesses. We believe this will be instructive to the Inquiry and we will make it available shortly.

Key elements of that work draw on established thinking in ARITA, and include:

- *Safe harbour* – It is ARITA's view that consideration needs to be given to providing a business judgement rule for insolvent trading, commonly referred to as a "safe harbour", to facilitate directors being able to undertake restructuring efforts in appropriate circumstances that may be in the best interests of the company and creditors. We note that directors should not be permitted to see the safe harbour provisions as a relaxation of their responsibilities and, rather, these should be seen as being heightened during this period by requiring positive and beneficial governance thresholds to be met before the rule can be used. Consideration should also be given as to whether, in situations where the safe harbour protections are not met, the insolvent trading rules should actually be easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors. This protected environment is an element of the US "Chapter 11" and the UK has an equivalent.

- *Ipso facto* – An ipso facto contractual clause allows one party to terminate a contract by reason only of the fact (ipso facto) of the insolvency of the other party. The Australian Law Reform Commission recommended that ipso facto clauses be void against a liquidator or administrator and this is also an element of the US "Chapter 11" (and also the UK model) that ARITA has consistently supported. It is ARITA's view that voluntary administrations are not as successful in restructuring businesses as they could be due to this. Ipso facto clauses have played a pivotal role in shutdowns such as One.Tel.

- *Chapter 11* – ARITA concurs with the Interim Report in its observation that Chapter 11 is a costly regime that "could leave control in the hands of those who are often the cause of a company's financial distress". However Chapter 11 is undergoing a major review in the United States in recognition that it may require significant reform and improvement. ARITA is monitoring the progress of that review.

  ARITA has not previously supported the adoption in Australia of other elements of Chapter 11 such as their fully court-supervised model where stakeholders are generally individually legally represented and, in turn, have their own accountants and advisers through the process. This aspect adds a multiplier cost and complexity to Chapter 11 turnarounds. We consider this would have a deleterious effect of further eroding remaining creditor assets.

Other key points:

- The insolvency regime currently applies a "one size fits all" approach. ARITA is considering the benefits of streamlined liquidation and restructuring processes for micro businesses which account for approximate 60% of all external administrations. Furthermore ARITA is working with Chartered Accountants ANZ and CPA Australia to assess best practice in comparable international insolvency regimes and consider the options for SMEs in Australia. There are risks and benefits associated with any decision to streamline the insolvency process. Whilst the process may become quicker and cheaper, the savings must necessarily arise as a result of removing something from the process that is currently undertaken by insolvency practitioners - such as their independent investigations, reporting to creditors and ASIC, and recovery actions that are a fundamental cornerstone of the current liquidation process.

- In relation to the regulation of the insolvency profession, ARITA supports a single regulator for both personal and corporate insolvency practitioners, as recommended by the 2010 Senate Inquiry Report. If that is not to be implemented, we nevertheless support the proposed reforms in the Insolvency Law Reform Bill 2013, in particular in relation to the alignment of the processes of regulation of the profession by ASIC and AFSA and the potential involvement of ARITA in a co-regulation process. We commend the Inquiry to the draft Bill.

- There is a cost to restructuring, whether that is undertaken informally, by way of consultants and advisors; or formally via a voluntary administration or scheme of arrangement. If a business is to be viable into the future, it must be able to bear the cost of the restructuring process. Those costs should be considered an investment in the future of the business. It should be noted that in many, or even most, SME liquidations, the company has little or no assets remaining, such that while the liquidator may well have time-based fee entitlements, the entitlements are not realised by way of payment for the work done. The insolvency profession, in effect, contributes significantly to the operation of the insolvency regime.

- The public interest responsibilities of liquidators are not well understood by creditors and the community. In addition to a primary duty to recover assets and pay dividends to creditors, liquidators are required to investigate the conduct of parties leading up to the liquidation, report offences and other misconduct to ASIC, and assist in the pursuit of such misconduct. That is why ASIC itself refers to liquidators as the "front line investigators of insolvent corporations".

- The insolvency laws should be modernised to allow for the speed and cost advantages of email and internet and other technology based processes.

The ARITA Code, the improved regulatory processes under the ILRB, and the oversight of the courts, all provide an effective basis for the maintenance of high standards of liquidator conduct. ARITA itself has effective complaints-handling and disciplinary processes and is working to further improve them.

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2 ARITA thought leadership

ARITA has commenced a thought leadership initiative with the objective of reviewing the operation of Australia's corporate insolvency regime as a whole, and make recommendations on how the regime should be structured to optimise the restructuring of viable businesses and ensure the efficient reallocation of the capital of those businesses which are no longer viable.

While the framework is formative and open to an extensive consultation and redrafting process, some of the key issues that will be ventured include:

- the need for earlier intervention in distressed businesses and the promotion of reform that encourages that;
- the consequent limiting of potential liabilities for those working in that earlier stage by way of a "safe harbour" protection from liability for insolvent trading for directors; but only for those who meet certain strict criteria around obtaining advice and maintaining good financial management;
- the adoption of aspects of relevant international arrangements suitable in the Australian environment, such as the prohibition of "ipso facto clauses", based on US and UK law; the streamlining of Chapter 5 of the Corporations Act; and the alignment of personal and corporate insolvency law.
- consideration of distinct approaches to the restructuring and insolvency needs of each of large, SME and micro businesses; and
- greater opportunity for the restructuring of businesses outside of the formal insolvency regime; this is linked to the safe harbour protection above.

Consultation on ARITA's thought leadership will be being undertaken with our members and others with an interest in the improvement of Australia's corporate insolvency regime over the coming months. ARITA will keep the FSI informed as to the framework that is developed as it may be of relevance to the FSI's recommendations concerning external administration.

3 Chapter 3 Funding - External Administration

3.1 Policy options for consultation - Questions

3.1.1 Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

In the experience of our members, a company is almost always insolvent prior to entering into voluntary administration. This is supported by the fact that the law requires director/s to formally resolve that the company is insolvent or likely to become insolvent prior to appointing a voluntary administrator.

As such, it is not the appointment that results in the failure of the business, but rather the failure of the business that results in the appointment. Once the appointment occurs, there are consequences outside of the control of the external administrators which can limit their ability to maintain the business and preserve value as a going concern, other than that inherent in tangible assets.

3.1.1.1 Stigma of formal insolvency

Despite the critical role the insolvency regime plays in the efficient allocation of capital, there is a widely held stigma associated with insolvency in Australia. Whether it is bankruptcy for an individual[1] or voluntary administration/liquidation for a company[2], calling in an insolvency practitioner is not well regarded by the Australian community. As a result, this impacts on the ability of a company to be able to use formal restructuring and insolvency mechanisms such as voluntary administration (under Part 5.3A of the *Corporations Act*) to facilitate the turnaround of the business.

This can be contrasted with the US, where there is a different emphasis on how to react to insolvency[3]. ARITA research in Australia shows that currently it may well be correct that voluntary administrations are not resulting in the turnaround of the business for a large proportion of companies using them[4].

We see this arising from a combination of factors including:

- the stigma of insolvency resulting in directors responding to underperformance of their business by delaying in seeking expert advice;
- a lack of a "turnaround culture" in Australia, which may largely be driven out of a fear of liability for insolvent trading so that directors are not prepared to seek alternatives to formal insolvency once there is financial distress. We address this issue at 3.1.1.2 below;
- the value destruction of a business caused by customers' and suppliers' exercise of ipso facto clauses which we address at 3.1.1.3 below;
- possible concerns around the potential for a 'run' on any business where it becomes public knowledge that there are concerns around its solvency or a need for restructuring; and
- directors of companies not being aware of the options available in addressing "endemic" and "temporary" distressed situations.

By undertaking reforms that:

- improve the effectiveness of voluntary administrations as a formal restructuring tool;
- create an environment where directors are able to undertake restructuring of a business outside of formal insolvency without the risk of incurring personal

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[1] Sylvia Pennington, 19 June 2013, Go for broke – insolvency can be the best solution, The Sydney Morning Herald

[2] Clive Lee, 12 December 2008, Australia: A second chance through voluntary administration?, Mondaq

[3] Cameron Cheetham, 2 February 2012, Ipso Facto clauses and insolvency, Clayton Utz Insights.

[4] Mark Wellard, Terry Taylor Scholarship 2013, *A review of deeds of company arrangement,* which found that in 72% of cases a deed of company arrangement delivers a quasi-liquidation outcome. However, for 28% of deeds a successful restructuring appeared to be the outcome.

liability for insolvent trading if certain strict criteria around obtaining advice and financial management are met;
- result in quality directors being able to be attracted and retained by businesses in times of financial stress; and
- foster a culture whereby all stakeholders in the process work together to achieve an outcome,

ARITA considers that Australia will develop a restructuring environment which will enhance the operation of an already world class insolvency regime. However, for this to be accepted and successful, all stakeholders will need to make a conscious effort to change current public perceptions of mistrust and punishment and encourage the support for a business to be given a second chance where appropriate.

3.1.1.2 Influence of insolvent trading laws on the decisions of directors

Insolvent trading laws[5] are intended to make directors act to prevent a company from incurring a debt if the company is insolvent at the time the debt is incurred, or becomes insolvent as a result of incurring the debt. Directors who trade whilst the company is insolvent face civil liability for debts incurred, which can be substantial; and criminal prosecution, which can result in imprisonment.

It is our view that these laws do not work as intended for the following reasons:

1. In the case of larger companies with directors that are independent of the owners of the company (or listed companies), directors are generally educated and informed of their obligations, duties and risk of personal liabilities. They are also concerned about their reputation of being associated with a "failed" company. As such, when a company is in financial distress, they are more likely to want to take steps to appoint an administrator to end the potential of insolvent trading liability, rather than "risk" an informal restructure even if the company could potentially be turned around. Thus the insolvent trading laws act as a deterrent to restructuring attempts, even when a restructuring may be in the best interests of the creditors and the company. In this situation, there is an inherent conflict for directors between protecting themselves from personal liability and acting in a way which is in the best interests of the company and creditors.

2. In the case of SMEs where the directors are also generally the owners of the company, the directors' personal financial affairs are usually inexorably related to the financial affairs of the company and once the company is in a state of financial distress, the directors may well be too. With nothing left to lose, but a lot to gain if the business is able to continue, the distant threat of liability for insolvent trading is not enough to prevent the directors from continuing the business until there is nothing left to continue with[6]. Thus arguably, the insolvent trading laws do not act as an effective deterrent to reckless trading, particularly in the SME sector.

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[5] Primarily s 588G of the *Corporations Act*

[6] ASIC statistics support this with 61.1% of companies in external administration having less than $10,000 in assets and 40.1% having less that $1 (Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013).

3. It is inherently difficult for directors to assess the insolvency of their company in real time. Whilst under law a company is either solvent or insolvent, in reality a company can teeter on the edge of insolvency for some time and determining whether any business of even moderate size is insolvent is difficult unless it is clearly insolvent – even by an experienced insolvency practitioner.

4. Historically insolvent trading actions are difficult to prove and expensive to pursue. The reality that there are limited or no assets in a large number of administrations means that insolvent trading claims are unlikely to eventuate, particularly in SMEs where the claims are likely to be at the smaller end. Furthermore, asset protection strategies employed by directors and the fact that secured creditors and a number of trade creditors will hold personal guarantees from directors, means that often directors are unable to meet any compensation orders if an insolvent trading action is proved against them. We do recognise however that the threat of an insolvent trading action can result in out of court settlements in liquidations and payments under deeds of company arrangement to prevent further action being taken, resulting in benefits for the creditors.

It is clear that there is significant doubt as to whether the insolvent trading laws are achieving any of their objectives, but may instead be preventing directors from undertaking restructuring efforts in situations where that may be in the best interests of the company and creditors. It is ARITA's view that consideration needs to be given to providing a business judgement rule for insolvent trading, commonly referred to as a "safe harbour", to facilitate directors being able to undertake restructuring efforts in appropriate circumstances.

This protected environment is an element of the US Chapter 11 and the UK has an equivalent.

Much work has already been done on what the terms of such a safe harbour should be[7]. ARITA's views have not largely changed since our 2010 Joint Submission with the Law Council of Australia and the Turnaround Management Association. In summary, we support a business judgement rule with the following elements, that the directors[8]

- make a business judgement in good faith for proper purpose;
- after informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate;

[7] The Minister for Financial Services, Superannuation and Corporate Law released a discussion paper on 19 January 2010 titled "Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration". ARITA (then the IPA) made a submission jointly with the Law Council of Australia and the Turnaround Management Association Australia dated 2 March 2010 and we also made a supplementary submission of our own dated 18 March 2010. Copies of our submissions are available from the ARITA website.

[8] Taken directly from the ARITA (then IPA), Law Council of Australia and the Turnaround Management Association Australia joint submission dated 2 March 2010 in response to the discussion paper "Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration"

- rationally believe that the judgement was in the best interests of the corporation;
- the director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed;
- the director was informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time;
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring; and
- the director took all reasonable steps to ensure that the company diligently pursued the restructuring.

Our joint submission put forward 5 principal reasons for why there should be a safe harbour defence to insolvent trading liability:

1. the existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts;
2. the adverse effect of the existing laws on honest, capable directors, particularly non-executive directors;
3. the focus of directors of a financially troubled company should primarily be (as it is everywhere else in many other comparable jurisdictions) on the interests of creditors;
4. the existing insolvent trading law limits the options available to deal with financial distress; and
5. a safe harbour defence would promote the critically important policy objective of obliging directors to obtain early restructuring advice.

We see these principal reasons as continuing to apply.

We note that directors should not be permitted to see the safe harbour provisions as a relaxation of their responsibilities. If anything, their responsibilities should be seen as being heightened during this period by the business judgement rule requiring positive and beneficial governance thresholds to be met before the rule can be used.

Consideration should also be given as to whether, in situations where the safe harbour protections are not met, the insolvent trading rules should actually be easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors.

3.1.1.3 Effect of ipso facto

An ipso facto contractual clause allows one party to terminate a contract by reason only of the fact (ipso facto) of the insolvency of the other party. These clauses are found in all critical supplier contracts, franchise and license agreements as well as leases for land and equipment. Ipso facto clauses have played a pivotal role in the shutdown of major organisations that were in financial distress (examples such as the carrier contracts of One.Tel being terminated soon after the company entered voluntary administration resulting in One.Tel being unable to provide services to its customers, are obvious). It is ARITA's view that voluntary administrations are not as successful in restructuring businesses as they could be due to the fact that the moratorium in a voluntary administration does not extend to ipso facto clauses.

Under s 301 of the Bankruptcy Act 1966, ipso facto clauses are rendered void if the relevant obligor becomes bankrupt. However, there is no such prohibition in relation to corporation insolvency, and more particularly voluntary administration, under the Corporations Act.

As a result, if a financially distressed but viable business that is reliant on essential contracts continuing enters into voluntary administration, it is likely that:

- contracts will immediately be terminated;
- there will no longer be any business to restructure; and
- there will no longer be any value for creditors.

In some cases, directors may in fact be reluctant to place their companies into voluntary administration because of concern that this may result in creditors exercising their right to terminate under an ipso facto clause, and in effect terminating the company's business. This delay may weaken the company's chance of financial recovery.

The justification for such a moratorium being extended to cover ipso facto clauses is to ensure that important contracts of the business are maintained such that goodwill is preserved while the company is under administration. This serves to maximise the chances of the company and its business continuing as a going concern or otherwise maintaining its value to third parties. This is currently not the case in Australia and the experience of our members is that where the business is reliant on maintenance of contracts, voluntary administration sees the swift demise of the business due to termination of these contracts.

The Australian Law Reform Commission ("ALRC") in its General Insolvency Inquiry Report recommended that any contractual provision such as those discussed above be void against a liquidator or administrator[9]. The reasoning for the ALRC's recommendation was that there has been a similar provision in the Bankruptcy Act (s 301) since 1968. The bankruptcy provision was recommended by the 1965 Clyne Committee on the basis that to permit such an agreement to be terminated merely because of insolvency may sometimes have the effect of depriving the trustee of a

[9] ALRC 45, vol 2, s AT10. See also vol 1, paras 703 – 705.

bankrupt person of an opportunity to deal with the property comprised in such an agreement to the advantage of the creditors[10]. The ALRC adopted that reasoning and considered that it should apply with equal force to a company and recommended legislation to bring this into effect[11]. It is ARITA's opinion that this position is still correct, including in the corporate insolvency context.

Voluntary administration provides a limited and temporary moratorium against ipso facto clauses in some types of contracts once a company enters voluntary administration. Section 440B restricts the rights of landlords, secured creditors, and others during the voluntary administration process, but not contracts generally. We see the need for a restriction on the right to exercise rights under all ipso facto clauses at least for the period of the administration, which is generally some few weeks, with court approval for any extension of that period generally required.

The law in favour of the validity of ipso facto clauses is inherently counterproductive and contrary to the spirit of the Part 5.3A regime. We consider that the law should apply in the same way to contracting parties, subject to court leave, and subject to distinctions as may be necessary between different types of contracts. In our view, in cases where such contracts are in issue, that would be a very significant improvement in the effectiveness of Part 5.3A.

The US has a prohibition against contractors terminating a supply contract when a company enters Chapter 11. This is one element of Chapter 11 that ARITA has consistently supported[12]. ARITA has long recommended the law in Australia adopt this US approach as one way of countering the reduction in value of a business on its entering insolvency.

The UK is presently considering extending the avoidance of such clauses in telecommunications collapses[13], an area where our experience in Australia shows such a law is particularly needed.[14]

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[10] Clyne Committee Report, para 383.

[11] The recommended legislation was:

Certain provisions in agreements to be void

AT10. (1) Where a company is a party to an agreement (other than a charge) that contains a provision to the effect that, if the company commences to be wound up in insolvency or becomes a company under administration, then –

(a) the agreement is to terminate or may be terminated;
(b) the operation of the agreement is to be modified; or
(c) property to which the agreement relates may be repossessed by a person other than the company,

the provision is void, unless the Court otherwise orders, as against the liquidator or administrator.

(2) This section extends to agreements made before the commencement of this section.

[12] ARITA's first submission regarding the need for a moratorium on ipso facto clauses was it submission (then as the IPAA) in April 2003 to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into Australia's Insolvency Laws.

[13] Continuity of supply of essential services to insolvent businesses, UK Government, Open Consultation, 8 July 2014, closing 8 October 2014.

[14] ARITA is working with the Communications Alliance in Australia to address this issue in the telecommunications sector.

3.1.2 The Inquiry would value views on the costs benefits and trade-offs of the following policy options or other alternatives: no change to current arrangements; implement the 2012 proposals to reduce the complexity and cost of external administration for SMEs.

ARITA made numerous submissions, participated in round table discussions, separately consulted with Treasury and provide detailed input into the government's costings of the impact of the 2012 proposals, which now are pending legislation in the form of the Insolvency Law Reform Bill 2013 ("ILRB").

Whilst not in complete agreement, ARITA is largely supportive of the reforms proposed by the ILRB. We note however, that we are yet to see the consequential amendments to the Corporations Act or the Bankruptcy Act, or the regulations. The regulations in particular will hold significant details which will determine the practical operation of the ILRB.

In particular, the ILRB seeks to align the processes by which members of the profession are regulated by the two regulators – ASIC and AFSA, an alignment much supported by ARITA.

The ILRB also seeks to align other procedures under the Bankruptcy Act and Corporations Act, in relation to the conduct of meetings, and creditor engagement, though the full extent of the alignment will not be apparent until the regulations and consequential legislative amendments are available.

As such, although ARITA supports the ILRB and has dedicated substantial resources to its development, we are unsure at this time as to how much reduction in complexity and cost of external administration will result for SMEs.

As part of its thought leadership project, ARITA is considering the benefits of streamlined liquidation and restructuring processes for micro businesses[15]. Furthermore ARITA is working with Chartered Accountants Australia and New Zealand and CPA Australia to assess international insolvency regimes and consider the options for SME reforms in Australia. The results of this assessment will also be used in ARITA's thought leadership project.

[15] ARITA defines a micro business as one with unsecured creditors of less than $250,000. According to ASIC's Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013 external administrations of companies with less than $250,000 in liabilities comprise 61.7% of external administrations.

3.2 Interim Report comments

We now provide our views on specific comments made in the Interim Report.

3.2.1 Some submissions argue that the current regime is biased towards liquidation. They claim the prohibition on trading while insolvent, and its associated penalties, make directors more cautious in attempting to reorganise a business that could continue to be viable.

We refer you to our discussions at 3.1.1.1 above.

3.2.2 Stakeholders suggest that placing a company into voluntary administration can lead to the failure of a business that could survive with some restructuring, because voluntary administration processes can significantly devalue a company and involve significant cost.

There are two issues to be considered in respect of that statement – the effect of voluntary administration on the value of the company; and secondly the cost of the process itself.

3.2.2.1 Devaluation of the business

As to the devaluation of a business upon an insolvency appointment, this may well be correct given the nature of a formal insolvency administration and the customer and community perception of the vulnerability of its position. There is also the stigma associated with insolvency which impacts upon the value of a business that enters into a formal insolvency administration; we discuss that at 3.1.1.1 above. Herein lies some of the benefit of a "safe harbour" protection – whereby orderly wind down (either full or complete) may be undertaken in a more protected environment in which the assets of the business do not, themselves, become distressed due to the need for a pressured realisation.

As we discussed at 3.1.1.3, we consider that ipso facto clauses have a significant impact on the value of a business subsequent to an insolvency appointment and this is an issue that needs to be addressed.

3.2.2.2 Cost of external administration

There is a cost to restructuring, whether that is undertaken informally, by way of consultants and advisors; or formally via a voluntary administration or scheme of arrangement. If a business is to be viable into the future, it must be able to bear the cost of the restructuring process. Those costs should be considered an investment in the future of the business. It is also worth recognising that it is a long-standing and fully accepted practice for successful businesses to undertake reviews and engage expert advisers (management consultants, accountants, etc) to enhance their business performance – we suggest that the engagement of restructuring, insolvency and turnaround professionals is an analogous arrangement.

When considering the cost of a formal insolvency administration, it must be noted that the nature of insolvency is such that it can be an expensive exercise for a number of reasons – an experienced and qualified insolvency practitioner is required, who, most significantly, bears personal liability for the period of the appointment; their tasks are extensive in investigating and trying to find a solution; they have statutory reporting obligations to the creditors and ASIC; court assistance can be required; the affairs of the company are invariably in some disarray and its structure and business operations can be complex; the directors may or may not be co-operative; and the creditors' claims can be numerous and in dispute.

In addition to a primary duty to recover assets and pay dividends to creditors, liquidators are required to investigate the conduct of parties leading up to the liquidation, and report offences and other misconduct to ASIC, and assist in the pursuit of such misconduct. That is why ASIC itself refers to liquidators as the "front line investigators of insolvent corporations".[16] Payment of the liquidator for that work in itself consumes funds in the administration, often thereby reducing funds, if there are any, available to pay a dividend. These public interest and fiduciary responsibilities of liquidators are significant.

It should be noted that in many, or even most, SME liquidations, the company has little or no assets remaining[17], and those assets often prove to be insufficient to meet the liquidator's costs in full.

A study of court ordered liquidations under the 2012 Terry Taylor Scholarship[18] showed that, in the conduct of official liquidations, official liquidators annually:

- incur $1.9 million in disbursements;
- recover $0.5 million of disbursements from asset realisations;
- fund $1.4 million of disbursements from their own resources;
- incur $55.6 million in remuneration; and
- recover $8.3 million in remuneration from asset realisations.

The study concluded that official liquidators, on average, annually fund $47.3 million in unpaid remuneration from their own resources.

Under current ASIC requirements, an official liquidator is obliged to conduct a liquidation to which they are appointed by the court even though no funds are available for their remuneration. This is largely a product of Australia having no government liquidator. We do note that ASIC operates an Assetless Administration Fund from which practitioners may apply to obtain funding to prepare investigative reports to assist ASIC prosecutions, though our members report that funding may be difficult to obtain and doesn't fully remunerate for the work involved.

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[16] ASIC's Regulatory Guide 16

[17] According to ASIC's Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013, 61.1% of external administrations have $10,000 or less in assets, with 40.1% having less than $1.

[18] The Terry Taylor Scholarship is a research project funded annually by ARITA

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3.2.3 Other submissions suggest that the current arrangements are too complex and costly for SMEs.

3.2.3.1 Streamlined processes

A fundamental point we make is that the insolvency regime currently applies a "one size fits all" approach, such that Part 5.3A applies as much to a SME as to a large enterprise. To a large extent this is the case because, in general, corporate law itself makes no relevant distinction between large and small companies.

As mentioned at 3.1.2 above, ARITA is considering the benefits of streamlined liquidation and restructuring processes for micro businesses which account for approximate 60% of all external administrations[19]. Furthermore ARITA is working with Chartered Accountants Australia and New Zealand and CPA Australia to analyse international insolvency regimes and consider the options for SMEs in Australia.

There are risks and benefits associated with any decision to streamline the insolvency process. Whilst the process may become quicker and cheaper, the savings must necessarily arise as a result of removing something from the process that is currently undertaken by insolvency practitioners. That "something" is likely to be the independent investigations, reporting to creditors and ASIC, and recovery actions that are a fundamental cornerstone of the current liquidation process. The process will be more of a "cookie-cutter" approach, arguably no longer requiring the professional expertise of a registered liquidator. The risk of course, is without the pragmatic, independent insolvency expert overseeing the end of the company, there is a substantial risk that inappropriate conduct will not be detected, reported and prosecuted.

Careful consideration needs to be given to this issue due to the large number of SME businesses in our economy and the effect on the economy if poor business practices were to become the norm due to no or limited consequences for breaching the law. According to the Commissioner of Taxation's Annual Report 2012- 2013, small business accounts for 60% of the ATO collectable debt. The report further notes that taxpayers who do not comply with their obligations have an unfair advantage over their competitors and the same would be said of companies who breach other laws without fear of detection.

The cost benefit analysis has obviously been undertaken in respect of personal insolvency, as around 85% of bankruptcies are consumer bankrupts with little to no assets. These bankruptcies are dealt with in a largely procedural manner by the Official Trustee. Furthermore, Part IX Debt Agreements were introduced in 1996 to allow for the low cost restructuring of low income, low debt and low asset individual debtors and they now account for over a third of personal insolvencies and pay more in dividends to creditors than bankruptcies.

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[19] According to ASIC's Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013 61.7% of companies had less than $250,000 in liabilities.

The need for corporate insolvency to adopt the more expeditious measures taken in personal insolvency was the subject of a suggestion by the Hon Michael Kirby AC, CMG, at our national conference in 2010.[20]

Costs of insolvencies are in focus internationally. ARITA made a submission to a current UK consultation on remuneration; the report from which commented favourably on the Australian guidance and approach taken by the ARITA Code of Professional Practice on practitioners' remuneration.[21]

A useful comment made in that context, with which we in principle agree, was that the proposed UK reform focusing on remuneration was

> "trying to tackle the wrong problem. There seems to be an over-riding presumption, for example, that costs are too high but around 90 percent of these costs are made up by compliance with law. ... an ill thought through focus on cost reduction could risk innovation. Since the collapse of Lehman in 2008, we have seen the insolvency profession develop new and interesting ways of rescuing business, which have protected jobs and protected more of the value of the business. We must be careful that any changes do not change this culture of innovation and business rescue".[22]

3.2.3.2 Personal liability of business owners

The personal liability of business owners as directors will often exist irrespective of the insolvency of their company. The Interim Report refers to personal guarantees from directors required by lenders to businesses. The directors may themselves fund the business through personal borrowings. The tax regime imposes personal liability on directors in some cases, as a deliberate policy approach following the removal of the ATO's priority in insolvency in 1993, and the potential for this liability being imposed is increasing.

There are additional potential liabilities in insolvency, which are not limited to SMEs. There may also be breaches of general corporate law duties. Chapter 5 of the Corporations Act itself allows actions in relation to uncommercial transactions, director focused transactions and breaches of employee obligations, along with insolvent trading.[23] These allow liquidators to make financial recoveries, for the benefit of creditors, from those who may have been involved in absconding with company assets, including directors.

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[20] *Bankruptcy and Insolvency, Change, policy and the vital role of integrity and probity,* (2010) 22(2) A Insol J 4, Michael Kirby.

[21] ARITA submission to UK consultation paper - *Strengthening the regulatory regime and fee structure for insolvency practitioners*, 28 March 2014

[22] Insolvency regime reform is an opportunity for the UK to improve on its world class position, according to KPMG, KPMG UK press release 27 March 2014.

[23] See generally, *Keay's Insolvency*, Murray & Harris, 8th ed.

Whether these various personal liabilities should exist is a policy decision for the government. As mentioned above, ARITA is considering the benefits of streamlined liquidation and restructuring processes for micro business which may result in a lessening of some of the potential exposures in insolvencies.

3.2.4 In some cases, liquidator misconduct in areas of improper gain, including excessive remuneration, and liquidator independence and competence affect the cost of effectiveness of liquidation for SMEs.

3.2.4.1 Misconduct

We recognise that there have been isolated, but highly visible, examples of liquidator misconduct. However, we unequivocally reject the wording of this part of the FSI Interim Report as there is simply no evidence to support this claim. Further, we believe that pejorative and unsubstantiated stereotypes like this unnecessarily damage confidence in our financial system as a whole and undermine the effectiveness of insolvency practitioners whose role it is to shepherd businesses through an already traumatic and fraught process.

It is our view that only a small number of registered liquidators do not fulfil their duties and this is not representative of the industry as a whole. Indeed, the rigorous enforcement of ARITA's Code of Professional Practice yields few substantiated complaints of this type considering the inherently controversial role that is necessarily played by practitioners.

The most recent ASIC report on liquidator conduct[24] indicates good standards of liquidator conduct and a reduction in the number of complaints received by ASIC in relation to liquidators. Comparable reports by AFSA, often in relation to the same persons,[25] support this.

Liquidators are highly qualified and experienced professionals who are required to have certain tertiary and further professional qualifications in accounting and law, and extensive experience before they are able to be registered by ASIC.

3.2.4.2 Professional standards

In 2008 ARITA issued a Code of Professional Practice ("Code").[26] The Code sets a high professional standard of behaviour for the profession, with seventeen principles and associated guidance on a range of conduct, remuneration and practice management issues. The Code must be complied with by members of ARITA. The

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[24] Report 389 ASIC regulation of registered liquidators: January to December 2013

[25] Most trustees are also liquidators. See www.afsa.gov.au

[26] The Code is available from the ARITA website at www.arita.com.au/about-us/arita-publications/code-of-professional-practice

courts have referred to codes of conduct as relevant to the assessment of a liquidator's performance of his or her duties.[27]

The Code is responsive to changes and developments in insolvency law and practice, with the third edition of the Code effective from 1 January 2014. ARITA supports the Code with targeted training courses on issues such as independence and remuneration and regularly presents on professional standards at ARITA conferences and forums.

3.2.4.3 ARITA's professional standards processes

It is important that the FSI is aware that ARITA is in the process of further developing its already robust and highly regarded member conduct regime. ARITA's member conduct regime is detailed on our website[28] and in our Constitution and Regulations,[29] and the outcomes of our disciplinary process are also published on our website.

At this time we are considering the creation of an independent tribunal to determine complaints and concerns about insolvency practitioners that arise largely under the current framework of the Code.

That Tribunal would also offer educative advice to the community about both personal and corporate insolvency and an ADR process to manage issues that do not require a formal disciplinary process. We believe that this approach would help close financial literacy gap issues that often drive complaints and, where an action against a practitioner is warranted, will display the appropriate lack of bias that all participants expect. In short, ARITA wishes to take a stronger self-regulatory role.

Further, at our most recent National Conference, ARITA welcomed Dr Robert Austin[30] to talk on extending our Code to new areas of focus in the restructuring and turnaround space. We believe that this is a critical element to ensuring higher levels of ethical practice in the pre-insolvency arena that is currently largely unregulated.

It is a fundamental focus of our thought leadership framework that early intervention in circumstances of financial distress is required. That earlier phase is at present under-regulated, including in personal insolvency; and raises potential for abuse of the commercial processes. Hence ARITA seeks to provide some of its own regulation, and the experience and knowledge of its members, for the better enhancement of the Australian economy. It is envisaged that the review of the Code for this purpose will occur during 2015.

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[27] *Dean-Willcocks v Companies Auditors and Liquidators Disciplinary Board* [2006] FCA 1438.

[28] www.arita.com.au/insolvency-you/complaints-and-member-discipline

[29] www.arita.com.au/about-us

[30] Dr Robert Austin 2014, Keynote presentation at ARITA National Conference Melbourne on the future of professional standards. Dr Austin is a former Judge of the Supreme Court of New South Wales, and an honorary member of ARITA. His details are at www.minterellison.com

3.2.4.4 Moving insolvency regulatory functions from ASIC to AFSA

On page 3-127 of the Interim report, the FSI raises the option of moving insolvency functions from ASIC to AFSA.

We see that there are benefits with having one regulator that is focused on the regulation of insolvency and attuned to the particular legal, fiduciary and public interest aspects of the role of liquidators and trustees. We note that this was recommended by the 2010 Senate report on liquidators and their regulation by ASIC. The government has not accepted that recommendation.

Single regulation and alignment of processes would, in our view, lead to cost efficiencies, for both government, practitioners and creditors. Our reference of the issue to the Productivity Commission in 2010 resulted in a report recommending greater alignment.[31]

ARITA itself regards its membership as a whole, in that we do not differentiate between our members that are trustees or liquidators. This is evident in the Code and in our Constitution. We consider it beneficial to see the regulation of the profession in the same way. Registered Trustees are invariably Registered Liquidators and the different regulatory approach taken to each is not beneficial to the profession.

However, an important issue is that whoever is responsible for the regulation of the industry, appropriate funding is provided to enable effective regulation to occur.

3.2.4.5 Cost of regulation

On page 3-111 of the Interim Report, there is discussion about the funding of ASIC's regulatory functions. ASIC also discusses this issue in detail in its April 2014 submission in paragraphs 188 to 212, where it promotes a user pays based cost recovery model.

In its submission, ASIC states that the regulation of insolvency practitioners costs $11 million per year. Firstly, we query this amount and readings of ASIC's own reports suggest that this is not correct, with the costs most likely cover the regulation of all ASIC's engagement with insolvency matters rather than merely the regulation of insolvency practitioners. A critical distinction. A spend of $11 million to regulate approximately 689[32] liquidators, implies an average cost of nearly $16,000 per liquidator per year which seems extraordinary. Looked at through a different lens, the $11 million spend resulted in ASIC taking4 civil actions and achieving 7 administrative remedies against liquidators in 2013/14[33] –a cost of $1 million per action.

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[31] Productivity Commission Research Report, August 2010, at 4.5

[32] Report 389 *ASIC regulation of registered liquidators: January to December 2013*

[33] Report 383: ASIC enforcement outcomes: July to December 2013 and Report 402: ASIC enforcement outcomes: January to June 2014

Given that ARITA already brings a well-respected oversight function to around 90% of the profession, we would suggest that further government support for ARITA's self-regulatory function is preferable, and warranted.

Secondly we would stress that the benefits of a well regulated insolvency regime extends to all companies, not just those that are currently in some form of external administration. If registered liquidators are required to meet the total cost of ASIC's regulation of insolvency, this cost would necessarily be passed on to the various insolvency administrations via increased fees hence the cost would be borne not by the perpetrators of corporate failure or the beneficiaries of corporate limited liability but by the "victims" of corporate failure– the unpaid creditors.

As such, if a cost recovery model is proceeded with, costs need to be borne by all who benefit.

We do note that AFSA operates on a costs recovery model, and absent a mechanism parallel to the registration of companies where a levy may be imposed, imposes a realisations charge, and other fees, to fund its operations.[34]

3.2.5 To prevent viable businesses from entering voluntary administration, some submissions suggest that Australia adopt the US Chapter 11 regime, or certain aspects of it.

We are not aware of which submissions the Interim Report refers to in this recommendation or the context of their claims. In the absence of those, we generally do not agree that Australia should adopt the US Chapter 11 regime per se, or indeed adopt any insolvency regime directly from another jurisdiction. There are dangers for any country in doing so. This is the subject of comment in the interim PPS report[35].

ARITA believes that it is important to understand what is meant by "Chapter 11" in the minds of most commentators. To many, Chapter 11 is simply a system that provides for a "safe harbour" and protected (ipso facto preservations) environment for restructuring, which we have already commented positively on in this submission. However, it is often not understood that the US system of Chapter 11 also includes a full court-supervised model where stakeholders are generally individually legally represented and, in turn, have their own accountants and advisers through the process. This aspect adds a multiplier cost and complexity to Chapter 11 turnarounds and is not widely understood by many proponents in the Australian context (the recent American Airlines Chapter 11 was reported as incurring some $375 million in consultant fees[36]). This is not an aspect of Chapter 11 that ARITA is supportive of for the delays that it can place into the process, the need

[34] See www.afsa.gov.au

[35] Interim report on the statutory review of the *Personal Property Securities Act* 2009, Bruce Whittaker, 15 August 2014.

[36] http://www.nytimes.com/2014/06/27/business/hundreds-of-millions-are-sought-for-firms-in-airlines-bankruptcy.html?partner=rssnyt&emc=rss&_r=1

for the development of a commercial court system in Australia and for the deleterious effect it would have on further eroding remaining creditor assets. Further, ARITA is not convinced that the Australia community would be accepting of another key aspect of Chapter 11 – that in which existing management who led the organisation into distress, would be allowed to largely remain in influential roles within the entity during a formal restructuring process.

However, as part of our thought leadership framework discussed at Part 2 of our submission above, we are considering the various and different insolvency processes in the UK, US and Canada. Furthermore, ARITA is working on a joint project with Chartered Accountants Australian and New Zealand and CPA Australia to assess international insolvency regimes and their approaches to the insolvency of SMEs.

Consideration of the adoption of aspects of a US style Chapter 11 regime in Australia has been the subject of various reports over a number of years, including:

- Senate Economics References Committee Report - "Inquiry into the Performance of the Australian Securities and Investments Commission" July 2014;
- Parliamentary Joint Committee on Corporations and Financial Services "Corporate Insolvency Laws: a Stocktake" August 2004; and
- Corporations and Markets Advisory Committee (CAMAC) "Rehabilitating large and complex enterprises in financial difficulties Report" October 2004.

There is also a range of academic literature on the topic.

None of these reports have recommended the implementation of a "carbon copy" Chapter 11 regime in Australia. The CAMAC Report found "no compelling need, or intrinsic shortcoming in the VA procedure, which requires or justifies adopting Chapter 11 as an additional or substitute corporate recovery procedure for large and complex, or other, enterprises". ARITA has generally agreed with this view and has done so since our submission to the Parliamentary Joint Committee on Corporations and Financial Services in April 2003.

However, we are aware that Ch 11 is widely and harshly criticised in its home jurisdiction and under review by the American Bankruptcy Institute in the United States and a report is expected by the end of 2014. ARITA will consider that report and reassess any relevant issues that arise from it. We note that a report on this review is being presented at the International Association of Insolvency Regulators' conference in Washington, USA, in September, which both ASIC and AFSA are attending.

We also note that while the US system has historically put more emphasis on a debtor in-possession framework with the goal to rescue and rehabilitate the distressed company, the European systems have a legacy of creditor-in-possession frameworks, like that of Australia. In recent years, and since 2008, European corporate finance has emphasised more diffused US-style capital market products and practices. As a consequence, European insolvency laws are changing to include Chapter 11 type approaches. A recent European Commission recommendation on its proposed "new approach to business failure and insolvency" has emphasised the need for laws to accept business failure and encourage entrepreneurs.[37] We understand that while there is a general trend towards more rehabilitative processes in Europe, substantial differences between countries remain, so that forum shopping occurs. It is said that the UK Scheme of Arrangement process is the established pre-insolvency forum of choice.[38]

In other words, the quality of a country's insolvency regime, and its international standing on current insolvency principles, can be a factor in whether international capital is attracted to that country.

3.2.6 Adopting such a regime would create more uncertainty for creditors by limiting their rights.

Creditors' "rights" are significantly affected by any insolvency, although the rights of secured creditors, such as banks and those creditors with security interests registered on the Personal Property Securities Register, are generally currently protected in Australia. Ultimately it is a policy decision as to whether Australia's current creditor focused insolvency regime remains.

It may also need to be considered whether the focus on creditors' rights creates an unhealthy moral hazard in the operation of businesses, such that creditors have an unjustified expectation of their protection in the face of a trading party's insolvency. The PPS regime offers suppliers and others a strong and effective process to reduce the risk of counterparty insolvency. However, it appears that Australian SME businesses do not yet avail themselves of the PPS protections and consequent good financial protection and risk assessment.[39]

The policy decision is largely between whether our creditor focused insolvency regime remains or whether there is recognition of the wider role that the debtor itself and its advisors can play in the restructuring of a business in appropriate circumstances.

In any event, ARITA is itself encouraging its members to try to engage earlier with distressed businesses, before they become insolvent, when greater opportunities for turnaround and reconstruction exist. Necessary guidance and ARITA Code obligations are being formulated.

It is however, essential to have a clear framework so that all parties to an insolvency or formal restructuring process understand where they stand in the process.

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[37] Brussels, 12.3.2014, C(2014) 1500.

[38] Fitch: Insolvency Regimes in Spotlight as Investors Look to Next Default Cycle, 13 February 2014

[39] Interim report on the statutory review of the *Personal Property Securities Act* 2009, Bruce Whittaker, 15 August 2014.

3.3 Other issues

3.3.1 Director knowledge and identity

ARITA, and others, have consistently said that the right to operate a limited liability company is a legal privilege. This view has been substantially reinforced by the experience of our practitioners in dealing with the directors of failed entities. This is so particularly in the insolvency context where the directors are generally not liable for the company's debts. In this regard, we consider that directors of all companies should be required to have basic knowledge of their obligations as directors. ARITA members appointed to insolvent companies consistently encounter directors, and sometimes their advisers, who have little or no understanding of their duties, obligations and potential liabilities as directors, particularly in the SME sector. Further, these directors often have inadequate financial competency.

There is also a need for directors to properly identify themselves when they set up a company. ARITA members have encountered fictitious non-existent directors of insolvent companies, or directors with aliases or with variations on earlier names used. Despite ASIC's business registry role, there is no current requirement to provide identity checks as part of the registration of a company or when reporting a change in directorships. We see the need for such identity checks as a means of countering unlawful phoenix activity.

An academic member of ARITA recently said that, in relation to the privilege of incorporation,

> "the government, as the grantor of this privilege, is entitled to demand certain standards be met, and has the right to withhold this privilege otherwise. This is not unreasonable or even uncommon. The privilege of being allowed to hold a driver's licence is dependent upon satisfying certain standards of ability, as well as the requirement to prove identity and pay a fee". [40]

The simple proposal that has been recommended is that each director be allocated a director identity number – a DIN – which would be recorded in relation to each company of which they were a director. The DIN would also serve to facilitate the process of directors establishing new companies. ARITA supports this proposal.

3.3.2 Crisis management of ADIs, insurers and superannuation funds

ARITA liquidator members have acted as insolvency administrators of major insurers, banks (ADIs) and other prudentially regulated entities; one prominent example was the failure of HIH Insurance.

We are aware that there is limited literature in Australia on the insolvency issues in relation to prudentially regulate entities, in particular, in the context of the FSI, in relation to ADIs.

[40] '*An Ounce of Prevention – Practical Ways to Hinder Phoenix Activity*', (2013) 25(3) A Insol J 16, Helen Anderson.

A detailed analysis of the Australian regime for the crisis management of banks, in comparison with international regimes, is soon to be published.[41] We can advise the FSI further on this if required. To assist the FSI's considerations in this regard please find attached an overview of the insolvency issues in relation to ADIs at Annexure B.

One other current issue is the impact of personal insolvency on self managed superannuation funds, and the use of such funds to protect assets from creditors. We can elaborate further on this if required.

3.3.3 Managed Investment Schemes

Our members have had significant involvement in administering the collapse of managed investment schemes (MIS) which have raised difficult and complex legal and factual issues. These have included Timbercorp, Willmot Forests and Great Southern, and their administrations are, in many cases, on-going.

We note that we made a submission to CAMAC in its major inquiry into MIS, which led to CAMAC's Report of July 2012 titled *Managed Investment Schemes*. It appears that the government was awaiting the outcome of a further aspect of CAMAC's inquiry, in relation to further issues raised in CAMAC's 2014 Discussion Paper. ARITA also made a submission to the issues raised in that paper. We note that CAMAC has since been disbanded and the responsibility for the CAMAC recommendations and its further discussion paper issues now lies with Treasury and government.

We also note there is a current inquiry into the structure and development of forestry MIS by the Senate Economics References Committee, for it to inquire and report by 27 October 2014. ARITA will be making a submission by the due date of 4 September 2014.

We can elaborate further on these issues if needed.

3.3.4 Legislation

The laws of insolvency are mostly contained in Chapter 5 of the *Corporations Act* 2001 and in the *Bankruptcy Act* 1966. Both are largely 'old laws', in their drafting, and are based on even older 19th century, and earlier, concepts. They are largely based on old English law, even though in many areas UK law has advanced to modernity.

One UK paper notes that its own insolvency law framework was established in the second half of the 19th century and that despite major revisions in recent times some of the processes in insolvency procedures are

[41] *Crisis Management in the Banking Sector,* Haentjens and Wessells, editors, is soon to be published by Edward Elgar Publishing. The Australian chapter is written jointly by Professor Ros of QUT, an academic member of ARITA, and chair of INSOL International Academics, and Michael Murray, Legal Director of ARITA, and visiting fellow at QUT.

> "essentially unchanged from these Victorian beginnings. Commerce, communications and credit have all changed greatly over this period - some parts of this insolvency framework, while important and relevant when first formulated, may no longer be relevant for today's insolvency market".[42]

As examples, corporate law processes are based on old concepts of close court involvement in insolvencies, leading to separate regimes within Chapter 5 of the Corporations Act for court and voluntary liquidations. Timing and stay arrangements are different for each type of administration. The priority of employee claims is difficult.

Even modern laws impacting upon insolvency have often added to the complexity; a recent example being the *Personal Property Securities Act* 2009[43] and certain tax law changes.

Tax laws are in fact a significant example as they are not necessarily developed with insolvency considerations in mind. As a result have unintended consequences when inconsistencies arise. Insolvency provisions in relation to tax are to be found, with difficulty, throughout the *Income Tax Assessment Act* 1936, the *Taxation Administration Act* 1953, the *Income Tax Assessment Act* 1997, the GST laws (where insolvent companies and bankrupts are termed "incapacitated entities"), and others.

Insolvency is necessarily cost sensitive and the costs of administering the insolvency are added to by undue legal complexity.

We do not consider it necessary to have only one piece of legislation, however, we do consider that the insolvency laws need a complete review and modernisation.

3.3.5 Technology

There is only limited use of technology permitted by insolvency law, for example by way of service of documents by email. Website notification is not permitted, although courts will make such orders under their general powers where appropriate. For example, in *RiverCity Motorway*,[44] the Court directed that the administrators inform creditors and others by means of post, facsimile or email, but that in respect of creditors for whom the administrators did not have such contacts, the administrators were to give notice on the 'Creditor Information' section of the website of their firm, PPB Advisory. The only section allowing the court to make such orders is the general remedial section in Part 5.3A of the *Corporations Act*, s 447A, which only applies to voluntary administrations.

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[42] *Red Tape Challenge - changes to insolvency law to reduce unnecessary regulation and simplify procedures* Consultation Paper, The Insolvency Service, UK, 2014.

[43] On 31 July 2014 Mr Bruce Whittaker delivered his interim report on the statutory review of the PPS Act to the Attorney-General and Parliamentary Secretary to the Prime Minister. It comments on the undue complexity of this new law.

[44] *Owen, in the matter of RiverCity Motorway Pty Limited (Administrators Appointed) (Receivers and Managers Appointed) v Madden (No 5)* [2013] FCA 1443

Most insolvency firms have website information for the access of creditors. These can be used for general communications with creditors, without court order. An example, that of Ferrier Hodgson, is referred to in *Sherwin Iron Limited*.[45]

But we also point out that the Australian Law Reform Commission's inquiry into privacy gave a response to ARITA's submission that favoured a bias towards protection of insolvency information rather than its publication.[46] Our submission in fact referred to the case of a bankruptcy trustee found to have breached privacy laws because of his firm's website notice about the bankrupt and the bankruptcy. The government has yet to decide on that recommendation of the ALRC.

We have said that insolvency is necessarily cost sensitive and the costs of the administration are a first priority before creditors are paid. It is also a process necessitating continuing communication with often a large number of creditors, including by way of meetings.

It is necessary to contain those communication costs as much as possible whilst remaining aware of the need for quality communication with the various stakeholders.

ARITA recommends that more legislative attention and permission be given to the use of technology. Indeed, we believe that this would be to the clear benefit of almost all stakeholders in an insolvency process, given that the default for contemporary business communications is, indeed, an online method. The UK is itself examining this issue; we can explain this further if required.[47]

In the area of personal insolvency, we consider that AFSA is making significant progress in the adoption of new technology in the administration of the personal insolvency regime,[48] for example in its online services and "desktop" audits of trustees. Again, this emphasises the difficulty of having separate insolvency regulators, and the potential for cost effective and uniform approaches to insolvency generally.

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[45] *Gothard, in the matter of Sherwin Iron Limited (Administrators Appointed) (Receivers and Managers Appointed)* [2014] FCA 826, at [16]

[46] ALRC 108, Chapter 44.

[47] Red tape Challenge – changes to insolvency law to reduce unnecessary regulation and simplify, The Insolvency Service, UK, 2014.

[48] See www.afsa.gov.au – Future online services

4 International comparisons

ARITA is aware of the need to monitor international developments in insolvency and it does so through a range of means and contacts. ARITA members are members of INSOL International, some are members of the INSOL Academics Group and of INSOL Europe. Many of our members have practised in relevant jurisdictions, including the UK, the US, Asia and Europe. Their knowledge and experience feeds into this submission. Should the Inquiry need further details on international insolvency regimes, we can readily access that information.

5 Conclusion

ARITA hopes that our comments are of assistance to the Inquiry. We are ready to assist with any direct contact as may be required.

We will keep the Inquiry informed as the progress of our thought leadership project.

Should you wish to discuss any aspect of our submission, please contact either:

- John Winter, CEO at jwinter@arita.com.au or 02 9290 5741
- Michael Murray, Legal Director mmurray@arita.com.au or 02 9080 5826; or
- Kim Arnold, Technical Director karnold@arita.com.au or 02 4283 2402.

Yours sincerely

John Winter
Chief Executive Officer

Annexure A

Relevant ARITA/IPA submissions

- 'Safe harbour' submission - ARITA (then the IPA)'s submission to Treasury jointly with the Law Council of Australia and the Turnaround Management Association Australia dated 2 March 2010; supplementary submission of ARITA dated 18 March 2010.

- Strengthening APRA's Crisis Management Powers – Consultation Paper – September 2012, ARITA (IPA) submission December 2012

- ARITA submission to UK consultation paper - Strengthening the regulatory regime and fee structure for insolvency practitioners, 28 March 2014.

Relevant government reports

- Productivity Commission Research Report August 2010, *4.5 Insolvency practitioners*
- Senate Economic References Committee, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework*, September 2010 report
- Senate Economics References Committee Report - "Inquiry into the Performance of the Australian Securities and Investments Commission" July 2014.
- CAMAC Report - Managed Investment Schemes, July 2012.
- *Red Tape Challenge - changes to insolvency law to reduce unnecessary regulation and simplify procedures* Consultation Paper, The Insolvency Service, UK, 2014.

Relevant ARITA journal and academic articles

- Mark Wellard, Terry Taylor Scholarship Report 2013, *A review of deeds of company arrangement.*
- *Bankruptcy and Insolvency, Change, policy and the vital role of integrity and probity,* (2010) 22(2) A Insol J 4, Michael Kirby.
- *An Ounce of Prevention – Practical Ways to Hinder Phoenix Activity*, (2013) 25(3) A Insol J 16, Helen Anderson.

Relevant other publications

- Keay's Insolvency: Personal and Corporate Law and Practice, Michael Murray and Jason Harris, 8th edn, Thomson Reuters, 2014.
- Orderly and Effective Insolvency Procedures, International Monetary Fund, 2 Aug 1999, Chapter 2.
- Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011)
- International Monetary Fund, Australia: Financial Safety Net and Crisis Management Framework, (Financial Sector Assessment Program Update, Technical Note, 2012)
- International Monetary Fund, Australia: Financial System Stability Assessment, (IMF Country Report No 12/308, 2012)
- 'Insolvencies, bailouts and resolutions: Dealing with banks when the music stops' (2014) 25 JBFLP 71, Ayowande A McCunn.
- Alan Tyree, Banking Law in Australia (7th edn, LexisNexis 2011)

- The Economic and Strategic Structure of Insolvent Trading, Michael J Whincop, 2000;
- Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 Modern Law Review 665.

Annexure B

Discussion of crisis management of ADIs, insurers and superannuation funds

It may assist if we offered a brief explanation of the insolvency issues in relation to ADIs on which the literature in Australia at least, is limited. The Banking Act 1959 contains a range of legal measures allowing APRA to maintain and regulate financial stability in the banking sector, and measures to allow a crisis management response by APRA in the event that it is required. The Act also allows the formal insolvent winding up of the ADI. These provisions are largely contained in Part II of the Act.[49]

If an ADI's financial position is in decline, APRA may decide to appoint an 'ADI statutory manager'. Typically that person would be a registered company liquidator, mostly likely an ARITA professional member. That manager takes immediate control of the ADI's business and has a range of powers and duties in effect to resolve the ADI's financial distress. The directors are removed and their authority is displaced. The ADI statutory manager must report to APRA as required. The manager can recommend action by APRA, including that APRA apply to wind up the ADI.

APRA may then apply under the *Banking Act* to the court for an order that the ADI be wound up and that an official liquidator be appointed to the ADI.[50] Separately, APRA also has authority under the *Corporations Act* to apply to wind up an ADI and have an official liquidator appointed. On the appointment of a liquidator, who would also most likely be an ARITA professional member, APRA may terminate the position of the ADI statutory manager.[51]

The winding up of the ADI would then largely proceed under the *Corporations Act* regime. Significantly, the court order for winding up allows the government to immediately implement the Financial Claims Scheme (FCS) by which depositors of the failed bank would be paid to a certain level. The liquidator has a significant role under the FCS in assessing depositors' claims and facilitating payment.

The 2012 IMF's Financial Sector Assessment Program broadly explains and assesses the Australian regime as follows:

"Powers for early intervention in problem banks (including to provide liquidity assistance) and to resolve non-systemic banks appear robust. Liquidity assistance in the first instance would be accomplished via the RBA's daily repo auction process; in the second instance, assistance would be negotiated on an individual institution basis, in consultation with APRA vis-à-vis supervisory and solvency concerns. The scope of eligible collateral that the RBA accepts through its normal market operations makes it extremely unlikely that an ADI would be unable to obtain adequate liquidity under most circumstances. Legislation grants APRA strong powers to direct ADIs to take corrective actions. Such powers (eg, the power to order a recapitalisation or to remove or replace directors and officers) could be used to facilitate the resolution of an ADI while it is under

[49] Banking Act, ss 7-36.

[50] Banking Act, s 14F.

[51] Termed an 'ultimate termination of control': Banking Act, s 13C.

private control. APRA also has appropriate grounds to appoint a statutory manager to resolve an ADI before it becomes insolvent. Powers to compel a purchase and assumption transaction are robust. APRA could issue a determination that an ADI should transfer assets and /or liabilities to a willing, healthy ADI, a bridge bank, or asset management company while the failing bank is under private control or under statutory management (including immediately before a winding-up). Winding up occurs through a court-based procedure with APRA involvement".[52]

The IMF did suggest further steps were necessary in relation to the preparation of recovery, resolution and contingency plans for systemic and other ADIs.[53]

The *Corporations Act* gives the liquidator extensive powers and discretions, including to sell the business of the company or any part of it. The *Banking Act* imposes some overlays by way of limiting and oversighting the role of the liquidator. For example, section 62C provides that before making any application to a court in relation to a matter arising under the winding-up of an ADI – for example to bring voidable transaction proceedings - a liquidator must advise APRA which is then entitled to be heard before the court. Also, section 63 requires the Treasurer to consent to any reconstruction of the affairs of an ADI that may be proposed by a liquidator. The *Banking Act* also imposes responsibilities on the liquidator to manage the FCS.

Beyond that, the *Corporations Act* is the sole source of how the winding up is to be conducted.[54] It requires the liquidator to gather in and realise assets, ascertain the creditors, take proceedings for recovery as may be possible, and pay dividends to creditors. Creditors' claims against the ADI are stayed, save for secured creditors. A liquidator may trade on the insolvent company's business only to the extent necessary to facilitate its winding up.

It is apparent that the ADI would have been "pre-positioned" for its winding up through the exercise by APRA of its statutory management and other powers. The funds of depositors would necessarily be assets of the ADI over which the liquidator retains control; a freeze on depositors' funds would apply but at the same time the FCS would immediately apply to allow payments to depositors to be made. A major task of the liquidator would be to assess and facilitate those payments. No other banking business could be conducted. Loan books of the ADI would continue to be managed and may be sold. These issues would be common in any comparable insolvency regime.

The winding up of an ADI would be potentially complex. However the *Corporations Act* is suited to dealing with the administration of large and complex insolvencies, a significant example being

[52] IMF, *Australia: Financial System Stability Assessment*, (IMF Country Report No 12/308, 2012) [5].

[53] IMF, *Australia: Financial System Stability Assessment*, (IMF Country Report No 12/308, 2012) [Table 1]. The nature of such plans – lately termed 'living wills' - is explained by the Chair of APRA: Dr John Laker, 'APRA's Regulatory Priorities – An Update', FINSIA Financial Services Conference, 25 October 2011.

[54] See generally Michael Murray and Jason Harris, *Keay's Insolvency: Personal and Corporate Law and Practice* (8th edn, Thomson Reuters (Professional) Australia Limited 2014).

that of HIH Insurance.[55] Australia also obviously has a well developed and experienced insolvency profession by international standards.[56]

Creditors of a bank are ranked and paid in the ordinary course according to the provisions of the *Corporations Act.* Depositors are creditors of the bank and as such they must prove for the amount of the debt and, subject to specific provisions mentioned below, would rank behind secured creditors and any preferential creditors such as employees. Also, APRA's costs of having an ADI statutory manager in control of an ADI's business are payable from the ADI's funds and are a debt due to APRA.[57]

A significant feature of the *Banking Act* is that it provides, in relation to both insolvent Australian banks and the Australian branches of insolvent foreign banks, that deposit liabilities in Australia receive a priority out of Australian assets. That is, the assets of the bank in Australia are to be available to meet the bank's liabilities in Australia in priority to other liabilities of the bank.[58] In support of these priorities, ADIs that take retail deposits in Australia are required to hold assets in Australia at least equal to their deposit liabilities in Australia.[59]

The Financial Claims Scheme

The FCS is only activated when APRA applies to have an ADI wound up and the Minister has declared that the FCS will be applied to that ADI. The Treasurer may seek advice from APRA, ASIC or the Reserve Bank. APRA may require the liquidator to assist APRA in paying account holders their entitlements, to which the liquidator must give precedence over any other aspects of winding up the ADI, including any requirements under the *Corporations Act.*[60] Priority is given to prompt payment to depositors; for example, the liquidator may admit a depositor's claim even if it has not been proved according to the requirements of the *Corporations Ac*t.[61] When depositors are paid, APRA then takes the place of each of the depositors as a creditor in the winding up of the ADI, and is entitled to receive a dividend in respect of those payments in the final winding up of the ADI.[62] Costs incurred by APRA in administering the FCS are admissible as a debt due to APRA.[63] The liquidator's remuneration and expenses are given priority.

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[55] See also Corporations and Markets Advisory Committee, *Rehabilitating Large and Complex Enterprises in Financial Difficulties Report* (2004).

[56] See www.arita.com.au

[57] Banking Act, s 16. These priorities apply over all other unsecured debts but subject to the statutory priorities for the application of assets of an ADI in Australia, under s 13A(3) Banking Act.

[58] Banking Act, s 11F in relation to a foreign bank and, s 13A(iii) in relation to an Australian bank. There is a similar priority to that found in the Insurance Act 1973, s 116.

[59] Banking Act, s 13A(4).

[60] Banking Act, s 16AJ.

[61] Banking Act, s 16AQ.

[62] Banking Act, s 16AI.

[63] Banking Act, s 16AO.

More information

As we have said, we have access to further information on this area, on which there is little academic or other comment in Australia, if required.