# Submission regarding insolvency law change

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## Summary

While some additional adjustments could be made, I strongly support Model B.

It is my belief that Model B both better cultivates a culture of innovation and entrepreneurship and is more simple and practical. With the focus placed on conduct rather than timing, and the onus of proof placed on the liquidator, directors would have a better control of the company, and can concentrate more on the actual management of business, instead of meeting formality requirements.

However, certain elements of Model A should also be incorporated into Model B, such as the unavailability conditions of ‘safe harbour’. There should be limitations to the application of ‘safe harbour’, lest it is abused.

I strongly oppose the mandatory appointment of a so-called ‘restructuring adviser’. Unnecessary regulation and bureaucracy is generally what hampers entrepreneurship in the first place. The last thing stakeholders of a company need is unwarranted further intervention.

## Comments on proposals

### Purpose of law change and ‘cultural shift’

The proposals paper accurately captures the zeitgeist of entrepreneurship in the current day and age. With the international geopolitical landscape shifting to isolationism exemplified by ‘Brexit’ in the United Kingdom and the election of Donald Trump in the United States, it is important now more than ever to nurture the Australian entrepreneurship spirit rather than relying on exports. Now is the time to ‘put Australia first’ (Anderson and Turnbull, 2017).

The submission of the Law Council of Australia rightly highlighted the significance of ‘cultural shift’, reducing the stigma related to business failure (Law Council of Australia, 2016). Indeed, changes are warranted for the insolvency law of Australia to ‘strike a better balance between encouraging entrepreneurship and protecting creditors’ (Treasury 2016).

Courage, not fear, lies in the root of entrepreneurship. Risk taking is an inherent part of any business endeavour: one cannot achieve business success without taking any risk. And laws that cultivate entrepreneurship should be the ones that nurture the courage to take risks, not bury business executives with unnecessary formality and paperwork.

The changes proposed in Model B is a move in the right direction, as they place more trust and confidence in business executives to work harder to turn their companies back to viability. It also provides simple and practical measures to maintain a balance between the interests of directors and those of creditors.

## ‘Restructuring adviser’

The appointment of a ‘restructuring adviser’ should not be mandatory, but can be a recommendation. It should be deemed as good corporate governance that companies voluntarily adopt.

This mandate is flawed in its nature and can cause unnecessary problems, because it ‘disempowered directors’, as the submission by Australian Institute of Company Directors (AICD 2016, p.5) rightly points out. Many factors affect business results, e.g. general economy, demographic changes, international relations, business cycles. The company may be operating with an appropriate strategy, and a little more time or minor tactic changes are all that is needed for the strategy to show positive effects. Hence, if companies engage with external advisers too early, it may not be beneficial to the company or its creditors, and only demonstrates a lack of trust and confidence in its directors. This is likely to affect the morale and reputation of the company adversely.

If the appointment becomes mandatory, it will likely only be a matter of time before the disclosure of the appointment becomes mandatory as well. This can further damage a company’s reputation.

Even if a company is to appoint a ‘restructuring adviser’, the accreditation requirement should at least be removed. As stated in the AICD submission (p.5), ‘a principles-based approach is preferable to such a prescriptive approach’. Every business is different, and there can be many sorts of needs that suit the company under ever-changing business circumstances. Adjustments in the accreditation process can only be retrospective, and almost guarantee to be detrimental to the turnaround of a company.

No accreditation can ever be sufficient to cater to the ever-changing needs in business. Hence, it is best to leave the appointment of a ‘restructuring adviser’ to a company if it so wishes. However, Model A appropriately places the appointment, if any, on the company, and not its directors. This rightly places the duty of a ‘restructuring adviser’ to the company.

In the event where Model A is eventually adopted, the appointment of a ‘restructuring adviser’ by the company, not the directors, should remain. This is also seconded by Australian Restructuring Insolvency & Turnaround Association (ARITA) (Winter 2016, p.15).

## Viability & insolvency

Even if I disagree with their conclusion, I acknowledge the appropriateness of the focus on 'viability', rather than 'solvency', proposed in the submission of ARITA. Indeed, certain happenings may render a company insolvent in the short run, but the notion of 'viability' rightly places the focus on the long-term well-being of a company.

As pointed out by ARITA, businesses may have 'specific circumstances', and the relevant factors concerning viability might be 'unique' (Winter 2016, p.15). This is an appropriate recognition of a potential issue. However, I disagree with their solution of leaving the discretion to determine viability to a 'restructuring adviser'. The idea of having the help of an 'appropriately qualified and experienced restructuring adviser' may sound good on paper, but it may very well prove to be fanciful in practice. Retrospective qualification or accreditation can never catch up with the pace of business in the current business environment.

## Availability of 'safe harbour'

I agree with the statement of the Law Society of New South Wales (Law Society) that 'further consideration' should be given to the 'possible consequences and effects' of applying the 'safe harbour' (Law Society 2016, p.5).

Though a commendable initiative that stresses entrepreneurship, the 'safe harbour' carve out proposed in Model B could potentially be abused by company directors. Considering their ultimate control and knowledge of the company, the liquidator and creditors are naturally placed in a disadvantage when it comes to gathering or presenting information related to the company. Company directors may manipulate or falsify the books or information to escape liability.

On the other hand, the 'safe harbour' carve out excludes directors who 'permit a debt to be incurred in order to realise the value of a viable business or asset', even though they might be 'acting reasonably to preserve value, jobs and returns' (AICD 2016, p.7). This is questionable, or perhaps even as some might say, 'very unfair'.

As stated in the 'Viability & solvency' section, viability has a long-term focus and deserves more emphasis, whereas solvency is rather short-term focused by comparison. Hence, the 'safe harbour' carve out should be extended to directors provided they can demonstrate they have acted in good faith and to the advancement of the company's long-term business viability.

### Onus of proof

The onus of proof should lie on the liquidator.

To cultivate an entrepreneurial business environment, trust and confidence should be assumed in company directors. After all, investing in another company or not investing at all is always an option for creditors if they distrust directors of a certain company. If creditors do decide to invest in a company, however, company directors should be assumed to be acting in good faith and for proper purposes unless proved otherwise. This is a necessary component of a viable business.

### Disclosure

I agree with McGrathNicol (2016, p.4) that no disclosure should be mandated in the event of a 'restructuring adviser' being appointed. Such disclosure will undoubtedly and adversely affect the reputation of a company, and will not benefit any party related to a company in financial distress.

However, I do not believe such an appointment is warranted, for reasons stated before. If there existed such a role, creditors and other interest groups would naturally keep pressing the Government to mandate to have the relevant details disclosed. Required disclosure would inevitably take place due to public pressure, and the efforts involved in this law change would be futile. All that would change is the increased compliance requirements for companies and their directors, which would likely hamper them from returning the companies to viability, contrary to the original intention of this legislation change.

## Attention to possible conflict of interests in submissions

Although inclined to trust the good intentions of other producers of submissions, I would also like to draw the Government's attention to the possible conflict of interests in submissions.

Some producers, for example the AICD, may be naturally inclined to advocate for the best interest of company directors; some producers, for example the Law Society or the LCA, may be naturally inclined to place more focus on practicality of the law; other producers, for example McGrathNicol or PwC, may be naturally inclined to advocate for the best interest of the liquidator.

This is not to comment adversely on their respective submissions, but rather simply pointing out the fact that there could be possible conflict of interests due to the natures of these organisations. I am of the view that this is worth the Government's consideration.

## General thoughts on the insolvency law change

As to answer the question of if, why, and how I would change the insolvency law in the UNSW Corporations Law assignment, I make the following points:

### If and why I would change the insolvency law

Yes, I would change the law along the lines of Model B.

As evident in *Westpac Banking Corp v The Bell Group Ltd (in liq)* (Harris et al., pp. 517-518), directors have a duty to consider creditors' interests. Even so, compared to international standards, Australia has relatively low default recovery rates. That is, creditors are generally only able to recover a small fraction of their investment. Australia's recovery rate for disbursement is only 29% on average, and the figure for recovery rate for remuneration is 15% (Phillips 2013, p.2). The recovery rate is 25.7% for India, and 80.4% for the United States (Breitbart 2016). Both at the low end of recovery rate, India has taken the approach of putting more emphasis on the ad hoc protection of creditors, whereas Australia has determined to focus on the long-term viability of companies.

I believe in the long-term approach that Australia is taking, and thus support the change.

### How I would change the insolvency law

I agree with the long-term focus envisioned in Model B, and the Exposure Draft which, it seems, has mainly adopted Model B. I believe the carve out option, rather than the defence option, would be more beneficial to the long-term viability of Australian businesses in general. A term for Prime Minister might be three years or one year and 362 days, but an established business might be passed on to future generations.

The Exposure Draft does not include the concept/role of a 'restructuring adviser'. I support this. This could bring tremendous benefits to business innovation and re-vitalisation for reasons stated before.

I also support the mechanism of 'evidential burden' proposed in the Exposure Draft. As explained in the Explanatory Memorandum (Treasury 2017, p. 14), directors should bear the burden of supplying relevant books and information, and not withholding any. The liquidator will then examine these evidences, and request for additional books and/or information if need be. This is simple, logical, and practical, as directors naturally have the advantage in this. It would be almost impossible for the liquidator to examine a document if they were not aware of the existence of such a document.

Subsequently, I also support that directors would not be able to provide additional information in their favour if they initially withheld this. Withholding relevant information upon reasonable request of the liquidator can and should be seen as dishonest conduct, which should in turn demonstrate that the directors have not acted in good faith.

## Recommended adjustments for Exposure Draft

Although repeatedly appearing in the Explanatory Memorandum, the concept of 'viability' does not appear in the Exposure Draft. I am of the view that it should be made clear that directors are required to take reasonable steps to return the company to long-term viability, instead of short-term solvency.

Guidelines should be provided for the process of a court of law reaching a conclusion whether an outcome would be a 'better outcome' (The Treasury, 2017, pp.8-9).

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