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2 December 2022

Committee Secretary

Parliamentary Joint Committee on Corporations & Financial Services

Parliament House, Canberra

By email: corporations.joint@aph.gov.au

Dear Secretary

Corporate Insolvency in Australia

The Society of Corporate Law Academics (SCoLA) welcomes the opportunity to make a submission to the Committee's Inquiry into corporate insolvency in Australia. SCoLA is the peak body for corporate law academics in Australia, New Zealand and across the Asia Pacific rim. The Association has over 100 members and has a role in fostering debate and discussion about corporate law reform, including corporate insolvency law reform.

SCoLA has an executive committee that includes academics from across Australia and New Zealand. The Executive convened a sub-committee of SCoLA's insolvency experts to prepare the attached submission. If the Committee has any queries in relation to matters raised in the submission we would be happy to respond further.

Yours faithfully

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Vivienne Brand

President, SCoLA

SCOLA
Society of Corporate Law Academics (SCOLA)

Submission to the Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Corporate Insolvency in Australia

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About the Society of Corporate Law Academics SCoLA

The Society of Corporate Law Academics (**SCoLA**) is the peak body for corporate law academics in Australia, New Zealand and across the Asia Pacific rim. SCoLA began in 1993 as the Australian Corporate Law Teachers Association and has held an annual conference each year since that time. The Association has over 100 members and has a role in fostering debate and discussion about corporate law reform, including corporate insolvency law reform. SCoLA has an executive committee that includes academics from across Australia and New Zealand and convened a sub-committee to prepare this submission.[1]

General Comments

We commend the Committee for undertaking a review of corporate insolvency law. With Australia coming out of the pandemic and the ending of many government financial support programs, there are many businesses that are in an economically fragile state and will need the assistance of insolvency practitioners to either avoid formal insolvency or effectively manage the winding down of their business. While the terms of reference are broad, they also tend to focus on particular aspects of corporate insolvency law, such as unfair preferences or the remuneration of liquidators. These are important matters for consideration, but it should also be recognised that insolvency law is inter-connected with the broader economy, financial system and affects many people within the community. Any change to insolvency law can have ripple effects that flow through not only corporate insolvency law but throughout corporate and commercial law. Well-functioning markets require an efficient and effective insolvency system to give creditors confidence to extend credit and to give employees, shareholders, customers and suppliers confidence that obligations will be met, and if not, will be dealt with in a fair and effective manner by an insolvency practitioner. The timeframe given to the Committee to undertake the review is not sufficient to conduct a detailed review of corporate insolvency law, although a general check-up of the system with some technical recommendations for improvement is feasible. ***We recommend that one outcome of this inquiry should be to refer a general insolvency law inquiry to the Australian Law Reform Commission (ALRC).*** Insolvency law reform is difficult and needs to involve a broad range of stakeholders and broad consultation with the public. This is not something that can be done effectively within a given parliamentary sitting term, so an ALRC referral is appropriate. The last time the ALRC looked at insolvency law was in the mid-1980s,[2] and much has changed about the economy, business systems and social attitudes to debt and insolvency. It is time to begin the process of a wholesale review of insolvency law and an ALRC reference is the best vehicle to do so.

Terms of Reference

We address the specific terms of reference below. One point of significance that should be noted is the fact that this is a corporate insolvency inquiry. The majority of micro, small and medium businesses (**MSMEs**) are conducted as sole traders or partnerships, not companies, and so these will come within the *Bankruptcy Act 1966* (Cth) and not the *Corporations Act 2001* (Cth). Any changes that are aimed at addressing MSME insolvency need to take this into account. Even if an MSME is conducted using a company form it is likely that the company's affairs may overlap with the individual owner/manager's

[1] The Society acknowledges with gratitude the work of Professor Jason Harris, Professor Christopher Symes, Associate Professor David Brown, Associate Professor Anil Hargovan, Associate Professor Beth Nosworthy and Associate Professor Michael Duffy.

[2] Australian Law Reform Commission, *General Insolvency Inquiry* (Report 45, 1988) (the **Harmer Report**).

affairs. The use of personal guarantees by company directors and shareholders for the debts of the company is widespread throughout the economy. There is little point in seeking to save a company in financial distress if in so doing the business owner will be sent into bankruptcy. When a small business goes into insolvency, the current law requires that different people be appointed as corporate liquidators and personal bankruptcy trustees, which just increases the level of cost and complexity involved in what is likely a small asset pool of personal and corporate assets. A modern insolvency law needs to acknowledge the special characteristics of MSMEs and provide streamlined and flexible options for addressing their financial problems. ***We recommend consideration be given to forming a single insolvency regulator under a uniform Insolvency Act, which is what exists in most common law countries.***

Term of Reference 1

As corporate law scholars we are not heavily involved in measuring or monitoring ongoing shifts in macro and micro-economic conditions, so we are not ideally placed to comment on this Term of Reference. However, we can attest to anecdotal evidence from insolvency stakeholders about changes in the insolvency market in Australia and we offer some brief comments.

The insolvency market may have changed permanently during the COVID pandemic. Government restrictions on commencing insolvency proceedings, and changes in enforcement approaches from major creditors such as the ATO and the major banks, have led to historic lows for formal insolvency appointments. While some types of insolvency appointments (such as creditors' voluntary liquidations) have increased this year, the numbers of court (compulsory) liquidations remain well below the pre-COVID period figures. We are also seeing continuing increases in deregistered companies (both voluntary deregistrations and ASIC-initiated deregistrations), which could suggest that for some MSME owners it is better to abandon their companies and have them deregistered rather than seeking the appointment of a liquidator or administrator. The numbers of deregistered companies are now in excess of 120,000 per year, which is more than 10 times the number of formal insolvency appointments.

It may also be the case that for many MSMEs, insolvency processes are simply too complicated and expensive to meet their particular needs. A small business that has a few suppliers, a small number of employees, a landlord and the ATO as major creditors may not need a liquidator to take over their business to deal with its financial problems. ***We recommend consideration be given to use of alternative dispute resolution processes to deal with financial distress rather than formal liquidation or restructuring which will impose tens of thousands in additional costs through professional fees***.

The lack of insolvency appointments may put increasing financial pressures on insolvency practitioners who also face industry funding levies from ASIC and annual practitioner fees.

We suggest that the Corporations Act section 9 definition of 'statutory minimum' be amended. At present it reads '(a) if an amount greater than $2,000 is prescribed – the prescribed amount; or (b) otherwise — $2,000'. There cannot be many who, if owed $2,000 (or presently $4,000), believe that the corporate debtor is insolvent and so then go to the expense of engaging lawyers to issue a statutory demand. With creditors' petitions in bankruptcy now at $10,000 the *Corporations Act*'s prescribed amount for the statutory minimum should be in the order of $10,000 and probably more appropriately, $20,000 (though admittedly this may derogate from the incidental utility of statutory demands in collecting smaller corporate debts for large and small businesses). The present statutory minimum, which was adjusted recently for the first time in decades, has not been amended in a timely fashion,

apart from the recent COVID measures. ***We also suggest attention to the monitoring of companies for non-activity that would suggest they are dormant or a so-called 'zombie company',*** which can be a related issue.

Term of Reference 2

It is pleasing to see insolvency reform regularly on the agenda of previous governments as part of attempts to improve the law and provide better outcomes for creditors. However, prior reforms have involved short consultation times (in one case as short as five days) and have produced legislation that contains flaws and limitations that impede its effectiveness in addressing the actual problems of businesses in financial distress. The Part 5.3B small business restructuring is a prime example of a wasted opportunity for reform. The regime was announced at the end of September 2020 and introduced into law on 1 January 2021. Despite dozens of submissions from industry groups and stakeholders, the draft legislation was largely enacted as proposed and since that time has only been used 161 times. This may be compared with the take up of Part 5.3A voluntary administration in its first two years back in the 1990s of over 2,000 appointments. The simplified liquidation regime is even less popular with less than 70 appointments in almost two years. The legislation is creating sub-optimal solutions that don't meet the market needs or wants. A lack of detailed consultation is a big part of the problem here. Broad based consultation, can help build consensus for change so that the reforms are shaped by community, industry and policy needs. We don't need more law, we need better laws that are fit for purpose.

We recommend:

1. ***Simplifying the Part 5.3B regime by increasing the maximum liabilities from $1 million to at least $3 million (the US subchapter V small business restructuring plan has a ceiling of US$2.5 million, but was as high as US$7.5m during the pandemic) and allowing unpaid employee entitlements to be made up within a restructuring plan.***

2. ***Further simplifying simplified liquidation by removing reporting obligations, shortening the timeframes for completion and making the entry criteria easier. At present the simplified liquidation process does not appear to be much cheaper or easier than a full liquidation.***

3. ***Expanding ASIC's administrative powers to claw back voidable transactions to cover all transactions under Part 5.7B and encouraging ASIC to issue more recovery notices to reduce the cost and complexity of recovery proceedings.***

4. ***Implement the Whittaker Report recommendations to improve the operation of the Personal Property Securities Act (PPSA). In particular, repeal Corporations Act 2001 (Cth) sections 588FL–FM and leave vesting with the PPSA itself. Furthermore, change the amendment demand procedure to adopt the New Zealand regime to simplify asset sales during insolvency and discourage vexatious registrations on PPSR.***

Term of Reference 3

We note that unfair preference claims now come within different regimes in simplified and full liquidations. Both forms of proceedings are typically used by liquidators to recover their fees rather than making distributions to creditors. ***We recommend making unfair preference rules the same as for simplified liquidations and, assuming same is constitutionally maintainable, to include preferences within the administrative recovery notice power of ASIC to help reduce costs of recovery.***

For insolvent trading trusts, we endorse the detailed recommendations of the Law Council of Australia and further endorse the implementation of the Harmer Report recommendations from 1988. It is vital that liquidators be permitted to exercise a statutory power of sale over trust assets that are covered by an available right of indemnity by the company in liquidation that was acting as trustee. Requiring liquidators to seek court appointment as receivers for sale is a waste of the trust assets that benefits no one.

With regard to the insolvent trading safe harbour, we recommend the implementation of the Safe Harbour Review's recommendations. In particular, clarifying the operation of section 588GA and ensuring that the safe harbour extends to cover transactions that may delay or hinder employee entitlements under Part 5.8A are necessary.

As for international developments, Australia should consider more flexible legislative options for insolvent debtors, such as what is being undertaken in India (with alternative dispute resolution processes and pre-packs for small businesses) and in Singapore, which includes a streamlined liquidation procedure and a more flexible scheme of arrangement procedure for large company restructurings that includes cross class cram downs and pre-arranged restructurings.

The *Cross-Border Insolvency Act 2008* (Cth) which amended the *Corporations Act* has been in operation since approximately 2009. Australia chose to keep in place in the *Corporations Act* provisions that previously provided relief in matters of cross border insolvency even after the Model Law on Cross Border Insolvency was implemented by the *Cross-Border Insolvency Act*. The remaining provisions (section 580 and 581) are what are known as 'aid and auxiliary provisions'. Essentially, under these provisions, upon receipt of a letter of request from a foreign court in a list of statutorily prescribed jurisdictions (the letter having been issued upon the application of a foreign insolvency practitioner), the Australian court is required to act in aid of and be auxiliary to the foreign court in all external administration matters. The form of relief or the range of orders that may be made are not provided by section 581. The situation has been criticised as having procedures that overlap, are complex and confusing, lack consistent guidelines and depend upon the inherently wide discretionary powers of courts. However, the situation has also led to some affirmation in that the cross-border laws do not specifically cater for the circumstances of distinct corporate group entities in different jurisdictions and so section 581 came to assist and produced the desired cost savings and coordination efficiency for the benefit of creditors in both jurisdictions.

Concern has been raised over some Articles in the Model Law, which now form part of our corporations law, and what can be done about it. One example is Rares J commenting on the scope, and modification or termination, of the stay and suspension referred to in Article 21(1) which is regulated under Article 20(2) by section 16 of the Act in *Kim v Daebo International Shipping Co Ltd* [2015] FCA 684 where he described the drafting as somewhat beguiling.

Justice Derrington extra juridically said in 2021:

> A not insignificant body of jurisprudence is developing in relation to the *Cross-Border Insolvency Act*, particularly in relation to important concepts such as the temporal operation of the definitions, the identification of the centre of main interest, and the concept of 'habitual residence'. The extent to which the developing Australian jurisprudence accords with, or

> departs from, that of other parties to the Model Law has not yet, to my knowledge, been the subject of any law reform process. Such an analysis may be useful in the not too distant future.[3]

Her Honour's suggestion should be given consideration and perhaps even supported by delegated legislation particularly as the Model Law is incorporated into Australia's *Corporations Act.*

Term of Reference 4

There is a common saying in insolvency practice that 'you can't save a patient who is dead on arrival at the hospital'. Australian corporate insolvency law builds on corporate law, and this takes the approach of a low barrier to entry coupled with significant potential penalties if the business owner fails to comply with the law. What is missing here are early intervention measures. Most businesses do not trade profitably and then just become insolvent overnight. Insolvency is often a slow decline over a prolonged period that ceases only when an external force (such as ATO enforcement) takes action against the owner/manager personally (such as through a director penalty notice). With the overlap between personal and corporate finances through personal guarantees secured over the family home, there is an incentive for business owners to trade on into oblivion because putting the business into insolvency means losing not only their business and their livelihood but possibly also their home and their marriage.

More needs to be done to offer support to small business owners higher up the decline curve. A whole-of-government approach is needed so that red flags such as late tax filings, underpaid superannuation, late filing with or a failure to respond to ASIC etc can trigger a government assistance through small business advice. The Australian Small Business and Family Enterprise Ombudsman has recommended a business viability voucher be provided to small businesses so that they can seek affordable advice, and ***we strongly support this initiative***. Many small business owners can't afford to seek high quality advice while the business is still trading so they rely on their tax agent when they do their tax returns. Specialist financial/turnaround advice should be promoted by government to discourage business owners from turning to pre-insolvency advisors to get around paying tax or other major creditors.

We also offer some suggestions on reforming Deeds of Company Arrangement (DoCA).

A legislative position should be taken on Creditors' Trusts

At present the guidance on creditors' trusts comes from a Regulatory Guide issued by ASIC (RG82) and which therefore holds marginal force. In particular, the Guide provides an outline of the information that ASIC considers material to creditors and which should therefore be disclosed to them when a DoCA proposal involves a creditors' trust. ASIC has identified special risks for creditors and has expressed their opinion that Holding DoCAs should not propose the subsequent creation of a creditor's trust unless all the information specified in RG 82 is provided to creditors voting on the holding DoCA. ***The legislature should decide whether this should form part of the law, perhaps by way of delegated legislation in the Corporations Regulations.***

[3] Justice Sarah Derrington, 'The Changing Face of Law Reform in Australia: Commentary into the ALRC's Inquiry into Insolvency, its Contribution to the Current Legal Framework and the Need for a New Review Given the Passage of Over 30 Years' (Speech, ARITA Expert Series: Insolvency, 11 November 2021) [23] <https://www.fedcourt.gov.au/digital-law-library/judges-speeches/justice-s-derrington/s-derrington-j-20211111>.

DoCAs that give no role to directors

There appear to be three options or choices for Administrators when they, or other parties, are drafting the DoCA. Firstly, they can choose in the rescue plan to ensure no director involvement and no resumption of director management. Secondly, they could draft the DoCA to allow the directors to resume their full role in management whilst quarantining the property or aspects of the rescue for the Deed Administrator. Thirdly, they could require the directors to have a major role in the implementation of the rescue plan with a limited role for the Deed Administrator and allow a full resumption of the directors' management role.[4] One of these options will then be agreed to by creditors.

A company must not exempt a person from a liability to the company incurred as an officer of the company under section 199A. Thus it is not possible to indemnify, insure or in other ways protect directors who are given a restricted or no role under a DoCA, despite them being exposed to ongoing directors' duties. The logic underpinning the denial of the company bearing the costs of the indemnification or exemption for directors of going concerns is absent for directors who are given a restricted or no role under a DoCA. ***Clarifications should be provided in Part 5.3A or in section 199A. Additionally, it might assist if the legislation was to articulate the governance duties that continue to apply for directors when a DoCA is running and these could add to the objects provision of section 435A.***

DoCAs/Liquidations and statutory derivative actions

Although the company will be responsible for taking action for the breach of the underlying general law duties, this may not be likely when the company is in financial difficulty. Under Part 2F of the *Corporations Act*, members do have the ability to bring a statutory derivative action (**SDA**) on behalf of the company: section 236.[5] There is conflicting authority on the ability of members to bring an SDA for a company in liquidation, and it is at least arguable that the members' right to bring an SDA is not suspended by voluntary administration or execution of a DoCA. In *Featherstone Resources Ltd*, Brereton J refused to grant leave to bring a derivative action to the members of a New Zealand incorporated company, subject to a DoCA under the *Companies Act 1993* (NZ).[6] His Honour denied the application on the basis that the NSWSC lacked jurisdiction over a foreign registered company, but then commented that even should the court have had appropriate jurisdiction, that 'Part 2F.1A does not apply in respect of a company in administration, for substantially the same reasons that, in *Chalwan v Euphoric Pty Ltd*, it was held not to apply to a company in liquidation.'[7] This assertion can be challenged, as Tobias JA (with whom Beazley and Bell JJA agreed) in *Chalwan* specifically considered that a 'company' under Part 2F was contextually required to be 'a going concern and not one under the control of a liquidator.'[8] The phraseology used throughout *Chalwan* is very specific – the references

[4] See Larelle Chapple and James Routledge, 'External Administration in Corporate Insolvency and Reorganisation: The Insider Alternative' (2015) 23(2) *Insolvency Law Journal* 69; Larelle Chapple and James Routledge, 'Board Turnover and Reorganisation Outcomes: Evidence from Voluntary Administration' (2020) 30(3) *Australian Accounting Review* 212 for a discussion on the role and incentives of directors during administration.

[5] As to derivative actions generally, see Michael J Duffy, 'Procedural Dilemmas for Contemporary Shareholder Remedies' (2004) 22(1) *Company and Securities Law Journal* 46.

[6] *In the matter of Featherston Resources Limited; Tetley v Weston* [2014] NSWSC 1139.

[7] *In the matter of Featherston Resources Limited; Tetley v Weston* [2014] NSWSC 1139 [31], citing *Chalwan v Euphoric Pty Ltd* [2008] NSWCA 52, 245 ALR 780.

[8] *Chalwan v Euphoric Pty Ltd* [2008] NSWCA 52, 245 ALR 780 [124].

are always to a company in liquidation, not a company under external administration. Although there is some logic to presuming that, while in the hands of a voluntary administrator, the members' right to bring an SDA may be suspended, on the basis of the reasoning in *Chalwan*, the same may not be said for a company which continues to trade on under a DoCA. ***Thus, Chapter 2F or Chapter 5's sections 477 and 442A should address this to give clarity for derivative actions during insolvency***.

DoCA timeframes

An introduction of a time frame for DoCAs could be justified by providing certainty as to when directors fully resume their duties and liabilities. It could also give additional direction to Administrators who are constructing the rescue plan.

Term of Reference 5

Insolvency practitioners conduct much of their work in the public interest, with most insolvency cases not involving payments to general unsecured creditors. There is no government liquidator in Australia (unlike in other common law countries such as the United Kingdom, Singapore and New Zealand) so the private insolvency profession is expected to take on jobs whether there are assets to pay their fees or not. The principle of 'swings and roundabouts' on fees is well known in the industry and it is widely believed that liquidators go unpaid in perhaps 30 or 40% of their appointments. A system that depends on professionals working for free is a broken system in our view and needs more government support, either through increased funding to the Assetless Administration Fund to provide a basic level of funding for low and no asset insolvencies, or through a government liquidator's office (such as an Official Receiver) to take on public interest work (which is what occurs in the UK).

Insolvency practitioners who are working in the public interest should not have to pay an ASIC fee recovery levy each year because unlike other ASIC regulated populations insolvency practitioners are working in the public interest and often without full payment of their fees. Insolvency practitioners should also have free access to ASIC registry data, which is required to do their job properly.

Consideration should be given to broadening the base of insolvency practitioners. The small business restructuring procedure can be undertaken by a registered liquidator who is registered only for Part 5.3B restructuring work and who may have less onerous work experience requirements than for a full liquidator. However, as at October 2022 only one practitioner has been registered by ASIC for Part 5.3B work, with all other restructuring practitioners being full liquidators. Increasing the pool of restructuring practitioners may make the process more competitive.

Term of Reference 6

A whole of government approach is needed for addressing corporate insolvency matters. Anecdotal evidence collected by SCoLA members suggests that the ATO and Fair Entitlements Guarantee recovery program are not always behaving as commercial creditors but are adopting regulatory approaches to insolvency, which leads to inconsistent outcomes in insolvencies. ***A more transparent recovery and enforcement policy should be adopted by these agencies. There also should be greater cooperation between ASIC, ATO, Fair Entitlements Guarantee and FWO to tackle illegal phoenix activity and untrustworthy advisors.***

The Assetless Administration Fund should receive increased ongoing funding and should be available to provide a basic level of funding for low and no asset liquidations.

There is also a need for more and better data about insolvency matters to be made publicly available to facilitate research and debate about the operation of the insolvency system. The Harmer Report in 1988 identified that '[b]etter statistical information is needed, particularly relating to corporate insolvencies.'[9] This remains the case. The Parliamentary Joint Committee conducted a comprehensive inquiry into Corporate Insolvency law in 2003–4 and commented upon the lack of data. In 2010 the Senate Economics References Committee *Report into Liquidators, Administrators and the Role of ASIC* also heard evidence of a lack of data and access. The Report recommended that there be a unit established that would be responsible for gathering, collating and analysing data on a range of corporate and personal insolvency matters. This data would be publicly available and free of charge. If such a unit were to be established, then it could be governed by an advisory board composed of representatives from government, members of the public, academics and the relevant professions. The advisory board could then assist the unit to establish its priorities.

The precise dimensions of problems and priorities in corporate insolvency are impossible to gauge due to a lack of data or a lack of transparency in making data available and accessible.

Term of Reference 7

The $2,000/$1,500 caps for excluded employees (directors, spouses and relatives) needs updating and indexing.[10]

Priority for wages and entitlements for excluded employees are limited and if these persons are owed more than the cap then the remainder is unsecured and unprioritised. In section 556(1A) there is a $2,000 limitation on wages payments in respect of 'excluded employees' for priority payments in section 556(1)(e) and this has been the same amount for three decades. In section 556(1B) the priority leave payments for these excluded employees is limited to $1,500.

The 1981 *Companies Code* introduced the concept of 'excluded employee' for persons associated with officers of the company. Surely even though there is a public interest aspect to holding back on priority amounts being paid to those who run the company ahead of unsecured creditors, the current amounts would represent a very low hourly rate compared to when they were selected last century.

The Explanatory Memorandum of the *Corporate Law Reform Bill 1992* states that 'Proposed subsection 556(1B) implements, in part, the Harmer Report's recommendation that it be made clear in the legislation that the limits applying to the debts which may be paid in priority to excluded employees only apply in relation to the amount of the debt which arose during the period in which the person was an excluded employee.' The *Corporations Act* does this through its application of 'non-priority days', which does not need reform. The Explanatory Memorandum in 1992 states the amounts are the 'same as the amount presently prescribed.' Given the difference between a dollar in 2022–3 and 1993 or even in 1981, '***excluded employee' amounts clearly should be indexed by the Corporations Regulations***.

[9] Australian Law Reform Commission, *General Insolvency Inquiry* (Summary Report, 1988) [7]; see Harmer Report (n 2) vol 1 [39]–[43].

[10] See *Corporations Act 2001* (Cth) s 556(2).