COMMONWEALTH OF AUSTRALIA

Proof Committee Hansard

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Corporate Insolvency in Australia

(Private)

THURSDAY, 23 MARCH 2023

CANBERRA

BY AUTHORITY OF THE SENATE

[PROOF COPY]

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Thursday, 23 March 2023

Members in attendance: Senator Scarr, Senator Pratt and Ms Mascarenhas

Terms of Reference for the Inquiry:

Inquiry into the effectiveness of Australia's corporate insolvency laws in protecting and maximising value for the benefit of all interested parties and the economy, including:

1. recent and emerging trends in the use of corporate insolvency and related practices in Australia, including in regard to:

a. temporary COVID-19 pandemic insolvency measures, and other policy measures introduced in response to the pandemic that may have had an effect on such trends and practices;

b. recent changes in domestic and international economic conditions, increases in material and input costs for businesses and inflationary pressures more broadly, and supply shortages in certain industries; and

c. any other contributory factors or events that have impacted insolvency patterns;

2. the operation of the existing legislation, common law, and regulatory arrangements, including:

a. the small business restructuring reforms (2021);

b. the simplified liquidation reforms (2021);

c. the unlawful phoenixing reforms (2019); and

d. the operation of the Personal Property Securities Act 2009 in the context of corporate insolvency;

3. other potential areas for reform, such as:

a. unfair preference claims;

b. trusts with corporate trustees;

c. insolvent trading safe harbours; and

d. international approaches and developments;

4. supporting business access to corporate turnaround capabilities to manage financial distress;

5. the role, remuneration, financial viability, and conduct of corporate insolvency practitioners (including receivers, liquidators, administrators, and small business restructuring practitioners);

6. the role of government agencies in the corporate insolvency system, including:

a. the role and effectiveness of ASIC as the corporate insolvency regulator;

b. the ATO's role and enforcement approaches to corporate insolvency, and relevant changes to its approach over the course of the COVID-19 pandemic;

c. the role, funding and operation of relevant bodies, including the Assetless Administration Fund and the Small Business Ombudsman; and

7. any related corporate insolvency matters.

WITNESSES

ERSKINE, Mrs Robin, Director, INSOL International

HARGOVAN, Associate Professor Anil, Executive Member, Society of Corporate Law Academics [by video link]

WELLARD, Associate Professor Mark, Academic Member, Society of Corporate Law Academics [by video link]

Committee met at 08:14

ACTING CHAIR (Senator Scarr): I declare open this private briefing of the Parliamentary Joint Committee on Corporations and Financial Services. The purpose of today's private briefing is to hear from representatives of INSOL International and the Society of Corporate Law Academics, SCOLA, on matters relating to the High Court's decision in Bryant v Badenoch Integrated Logging Pty Ltd [2023] HCA 2. This is a private briefing, and a *Hansard* transcript is being taken for the committee's internal use. A proof copy of the transcript will be provided to participants following the briefing. I remind committee members and witnesses that private briefing transcript evidence must not be released without the committee's permission.

I welcome the representatives from INSOL and SCOLA. Do you have any comments on the capacity in which you are appearing?

Prof. Wellard: I am from Southern Cross University.

Prof. Hargovan: I am from the University of New South Wales.

ACTING CHAIR: Thank you, everyone, for attending today. We're in your hands. How would you like to proceed? Do you want to walk us through the SCOLA presentation first? How's this tutorial going to run!

Prof. Wellard: I put a lot of thought into preparing some slides because of the nature of the subject matter. It is complex and it is hard to get points across simply verbally. So I thought some PPTs, particularly about running accounts, might help matters. I'm happy to kick off if my fellow witnesses are, and I am able to share my slides.

ACTING CHAIR: Okay. Thank you. We're in your hands.

Slides were then shown—

Prof. Wellard: Hopefully you're seeing these slides. You might have hard copies as well. But I might jump back and forwards just a little bit sometimes.

ACTING CHAIR: We've got hard copies.

Prof. Wellard: Terrific. Firstly, the key takeaways of this High Court decision—my academic colleague and I have spent some time assessing it, and I think there are actually some new anomalies, to cut to the chase, which arise out of the judgement, which I'll come to. Some of the slides which follow have graphic representations which will explain the points on this slide more clearly.

The key takeaway from the decision is really the first two points on that slide: the peak debt rule, such as it had been applied for a long time in the Australian insolvency law system to determine, where you do have a running account or a continuing business relationship, the extent of the preference. For a long time, liquidators had been able to apply, for the purposes of comparing levels of indebtedness—that's the way this running-account principle works. You have to compare the level of indebtedness at a starting point with a level of indebtedness at the end point—which is the beginning of the liquidation, effectively—to determine a preference. So, where you've had ins and outs or a running account, rather than looking at each individual payment independently, you need to take into account the broader picture, which is the payments made to induce further supply. You have, in short, a netting effect which means that, again, the creditor in that instance isn't hit with a preference claim for a large amount of every independent payment grossed up but rather is met with a claim for a preference which is arrived at through a netting calculation.

The issue has always been that, when you're comparing levels of indebtedness at a starting point to those at the end point, the end point's clear, but what's the starting point? Rather than looking at the peak debt of the relationship, or the account which has been traded under the relationship, as a starting point and comparing it with the debt at the end, the High Court has now decided that that's not the correct starting point. The correct starting point will actually be the start of the six-month period itself, which is the period within which preferences can be claimed back, ordinarily, unless you're dealing with related parties; or the date of insolvency if that occurs a little later than the start of the six-month period; or—and this is the third point which I'll come to, which is where I think we have a new anomaly—the beginning of the relationship itself.

I think that the scenario I'm about to put up on the slide will explain all this more clearly, rather than just verbally. Just on assumptions: to bring a preference claim, the liquidator has to prove a number of things. The first is that the company was actually insolvent when the payment was made. For the purposes of the scenarios I'm going to run you through, we're going to assume that there are no defences open to the creditor either. A creditor can defend a preference claim if they can make out a defence—for example: no reasonable grounds to suspect insolvencies. Those are quite separate from this issue of the netting arrangement, the running account principle. So we'll assume that we have actual insolvency established for the relevant period and we'll assume there are no defences.

The next slide really illustrates the takeaway points of the High Court's judgement in the Badenoch case. It was a unanimous judgement. The leading judgement was delivered by Justice Jago, with whom the other six High Court justices agreed. Prior to Badenoch, in this example here there's a running account—and I understand that the most prevalent example that we deal with in practice is the one here—where the start of the continuing business relationship predates the start of the six-month period. So when the six-month period begins, you already have a continuing business relationship in place.

As I've said, prior to the Badenoch decision, the way of calculating the preference would be to look at the peak debt. Of course, this is a very simplistic graphic illustration: the line going up represents supply on credit terms and the line going down represents a payment. The peak debt rule basically required that peak debt of $50,000 to be compared to the $10,000 balance at the end, giving a preference of $40,000. The Badenoch decision of the High Court means that the peak debt rule is not part of the law, such as it is in terms of applying this running account principle. Instead, we pick as the correct starting point, according to the High Court's judgement, the date of the start of the six-month period, assuming that the other elements of the claim, like actual insolvency—

ACTING CHAIR: Sorry, we might just ask some questions to help tease this out. I think this is a very useful slide. The six-month period that we're referring to here is the relation back-period, right? That's the six months before the start of a liquidation, where, potentially, a liquidator can apply to get an unfair preference set aside or claw back the money, right?

Prof. Wellard: Yes.

ACTING CHAIR: So if a payment is made earlier than that six-month period then those provisions in relation to unfair preferences do not apply. Is that correct?

Prof. Wellard: That's correct, unless, for instance, it's a related party creditor.

ACTING CHAIR: Unless it's a related party creditor or it's done to defraud the creditors or whatever.

Prof. Wellard: Correct.

ACTING CHAIR: So for the purposes of dealing with the usual run-of-the-mill interactions between business A and business B when business A goes into liquidation—business B might be a small business, it might be a subcontractor in the construction industry; we've heard from them—that six-month period is the key time, right?

Prof. Wellard: Absolutely.

ACTING CHAIR: When we refer to the start of the continuing business relationship, that's when the contract is entered into and the services and supply start—

Prof. Wellard: Correct.

ACTING CHAIR: The commercial relationship has started.

Prof. Wellard: Yes.

ACTING CHAIR: And peak debt is the practice that was adopted previously, before this case, where a liquidator will actually examine the balance in the account between the two businesses and identify the point in time during that six-month period when the debt has been at its highest. Then they simply compare it to the debt at the start of the liquidation and argue that the difference is the preference. Is that correct?

Prof. Wellard: Correct.

ACTING CHAIR: Okay. Over to you again.

Ms MASCARENHAS: That was useful.

Prof. Wellard: That was very well explained. As it was under the previous law, they would argue that $40,000 was the preference. The new law, post Badenoch, is that the starting point is the start of the six-month period—again, assuming a continuing business relationship is already in place. The anomaly, which I'll come to, and picking up on your point, Senator Scarr, is where the continuing business relationship starts during the six-month period. The court had some very interesting things to say in passing, in obiter, about that scenario, which is what gives us a new anomaly, but I will come to that very soon.

Ms MASCARENHAS: Just to make sure that I understand, now the preference is the difference between the 20,000 and the 10,000?

Prof. Wellard: That is correct, which means it becomes 10,000 instead of—

Ms MASCARENHAS: Thank you.

Prof. Wellard: Mrs Erskine might be able to speak to this more than me. In practical terms, you would expect collectively the quantum of liquidator preference claims to be diminished by this new statement of the law in terms of not being able to apply the peak debt to determine the extent of a preference. As I said, that is all clear where you have a continuing business relationship that is in place at the start of the six-month period. What about where the continuing business relationship commences during the six-month period? This is where we have a new anomaly. As I said, I don't think it is the most prevalent scenario that is dealt with in practice but it still is conceivable that you could have a running account that starts five months before liquidation commences.

In paragraph 58 of the judgement of Justice Jagot, again, with whom the other six High Court justices agreed unanimously, in dismissing the peak debt rule and holding and reasoning that it doesn't apply, made the point that it is largely unexplained in the decisions which have applied it. In my view, unhelpfully, the peak debt rule has been described in judgements going back as far as Chief Justice Barwick. Even Justice Neville on the Victorian Supreme Court—before he was on the High Court—talked about in terms of a liquidator's right to choose or a right of election, so it had a very arbitrary colour to it, which has been one of the main criticisms of the rule. But after acknowledging that the rule remains unexplained, Justice Jagot does acknowledge, it appears, in obiter that it is obvious that if the relevant relationship between the debtor and creditor starts at the first transaction between them, there could never be an unfair preference, because the account would stand at zero at that time. So it is taking your point, Senator Scarr, that the beginning of the relationship is the signing of the contract, not necessarily the debt which exists after the first invoice is struck.

In paragraph 77, acknowledging that there is this policy choice available between the two starting points, which we have looked at, Justice Jagot leaves aside the case in which the continuing business relationship itself starts during the prescribed period. That is where it I thought it would be helpful to illustrate the anomaly now exists albeit a statement in obiter by a High Court judge saying that something is obvious is a pretty strong statement, in my view.

Looking at the start of the continuing business relationship, which now is after the start of the six-month period, the debt balance at that time is zero, so no matter where the high water mark of the debt reaches during the running account, at the end you're either going to have a debt still owing, which means there is no preference or, even if it was fully repaid, a debt balance of zero, which means no preference. That illustration there is, in my view, a representation of that acknowledgement by her honour at paragraph 58 of the judgement.

So I think that is an anomaly which is brought into sharper relief by my next slide when you compare these two scenarios, B and C. Hypothetically speaking, and this can happen, you have a one-off supplier who, for the very first time, is dealing with the company during the six-month period, keeping it very simple—one supplies goods and services on credit terms and then a repayment. That $50,000 repayment would clearly be recoverable as preference. There wouldn't be any argument about that.

However, when you compare that to the situation of the continuing business relationship creditor who is dealing with the company for the first time during the period, it seems now that there is no possibility of a preference, notwithstanding that we have a high-water mark debt level there of $50,000. So we do have, in my view, a serious question as to whether there is a new anomaly and a situation where we are now treating to creditors differently. In fact, the continuing business relationship principle now is not simply levelling the field by giving you that netting arrangement; it is actually putting you in a better position than the one-off supplier scenario which I've illustrated there on the slide. So that's where the judgement gives us clarity, and clarity about whether or not we have a peak debt rule is welcome.

Again, I am not necessarily being critical of the judgement but one of the problems with the peak debt rule is it was very difficult to sustain on the language of the division of the provision. In the matter of statutory interpretation, it is hard to argue that the peak debt rule was a necessary feature of the provision, but we are now perhaps in a situation where we have replaced one anomaly with another. As I said, I think it is unhelpful that creditors are being treated differently. The question I put on the slide there is: Why is creditor B not liable to disgorge a preference in the situation I have put there—because, again, the debt balance is zero at the beginning and at the end—but a one-off supplier is liable to the disgorge preference? This is a bit of a rhetorical flourish. The other way I make the point is say you have a supplier with multiple independent suppliers that are not part of a continuing relationship, they have a peak debt to which it is applied. It just happens to be a peak debt that results from one transaction.

ACTING CHAIR: Just teasing that out and putting it in the context of the construction industry jobs—we've been looking at construction cases—someone is, say, in the process of building an apartment block. They are under financial pressure. What you are telling us is if, say, there is a firm that is providing services on a monthly basis over the course of a two-year period of construction—they've got that continuing business relationship—then you look at the start of the six-month period and compare it to the start of liquidation. There are payments being made, goods being provided. It may well be there is no unfair preference based on that analysis. But if you have someone who is doing a one-off supply of, say, generators or something, which are just as important for construction of the building, just as important to enhance the value of the assets, which benefits all creditors, in the former case it may not be found an unfair preference but in the latter case, notwithstanding the fact that the service or the goods being provided are just as important to assist the creditors overall, it will be considered to be an unfair preference because it is a one-off.

Prof. Wellard: That is correct. It is not a continuing business relationship.

ACTING CHAIR: So you can't have a continuing business relationship where there is a one-off transaction. Is that the view?

Prof. Wellard: Technically, it might be possible but the benefit of the netting arrangement, which flows from the continuing business relationship, won't be relevant because it is a one-off transaction. The point you made is really key to policy here. We hear a lot about the peak debt rule, or the continuing business relationship creditor being a creditor we want to incentivise to deal with and support companies in times of financial distress. I think the point you have made about other types of supplies without a continuing business relationship is very apt. They are equally important in times of financial distress and they are no less entitled to that consideration about the extent to which they are providing support. But it seems in their case, because they don't now have the benefit of the running account or the continuing relationship principle, they are more exposed to a preference than the continuing business relationship creditor is. I do think that's a new anomaly. I have debated this point with some other lawyers and academics. I have put on the slide here where the CBR starts during a period and how a court might try to work around that. But the problem is, and this is the takeaway point about the way the law works, you are assessing or netting a series of transactions but you are also having to compare levels of indebtedness according to a starting point and an end point. How those two things work together is awkward under our system. Whichever way you choose the starting point, you're going to end up with anomalies; that's the takeaway point. I'm very sympathetic to the view taken by the court that the peak debt rule, or the language of the provision, is not justified or sustained. But whichever starting point you choose, you're going to end up with, in my view, some anomalies.

Before I come to what I think is an interesting comparative reference, which is the US approach: as a matter of policy, looking at that example there—I could put up the first one as well—and as a layman's assessment, putting aside the statute and agonising arguments about statutory construction, has there been a preference there? What do we think? I take the view that the peak debt rule was explainable because the high-watermark debt was $50,000, just as a one-off supplier at that point in time who extended goods and services to the tune of $50,000 would have a debt vulnerable to a preference of prepaid as well. One of the unhelpful things in this whole debate has been the explanation of the rules being a liquidator's election. I can understand why people, including judges and creditors, have reacted adversely to that. It has the colour and arbitrary right of a plaintiff to maximise their claim, which is never going to be met with much sympathy. Unhelpfully, that explanation for the rule has overshadowed a debate, if you like, about whether the peak debt rule makes sense in policy terms. That's the highwater mark of the debt. That's the highest the debt ever got to. Why shouldn't that be the comparative starting point?

That point is reinforced when we look at the US approach. It's something Associate Professor Hargovan and I have been looking at recently. Rather than picking a starting point to compare levels of indebtedness, the starting point of the US approach, which is subsequent new value, is that you acknowledge at the outset there are three payments in this scenario which could be attacked as a preference. They have a shorter 90-day period, which, incidentally—and Associate Professor Hargovan will go into wider policy considerations. If this was the subject of a root-and-branch review, for instance, it might be something that's on the table—whether we shorten our period and make other amendments and look at the defences—but I'm focusing on assessing the extent of preferential effect. You've got three payments there which could potentially be preferences. The way the US system works is you can set off subsequent new value which has been provided—so subsequent supplies on credit terms—and you can use the subsequent new value supplies to set off the preference claim for all prior payments, not just the immediately preceding payments. You've got payment 1 and payment 2 offset by two supplies there of $30,000, which gives you a total of $60,000. In effect, those two subsequent supplies, after repayments of $60,000, wash away a preference claim for those first two payments. That would leave you with payment 3, which would be recoverable as a preference.

The crescendo of my argument here is that I assess this as giving you the same result the peak debt rule approach would give you, in the sense the last payment is recoverable as a preference and it's the difference between what happened to be the peak debt during the period and the start of the liquidation. But it's not described as the peak debt rule. As I said, you start with transactions and then you look at what subsequent new value can be used to set off against the preference claim. I think it is interesting that, in that example anyway, the result in the US approach would give you, in my view, the same outcome our former peak debt rule would have provided. Again, you're ignoring the balance owing at the start of the period. You're just looking at each payment and recognising that, if you're a creditor who's supporting a company in financial distress—or, even putting that to one side, you're simply giving new value through new supply and credit terms—you get the benefit of that subsequent new value supply and it minimises your preference claim.

Finally, this just highlights, in my view, one of the misconceptions of the peak debt rule in terms of misconceived criticism of the peak debt rule. It was often said the peak debt rule ignores the transactions prior to the peak debt, but my view has always been quite the contrary. The peak debt rule still ensures that payments prior to the date of the peak debt are not grossed up and they're not assessed independently. You are actually still giving the creditor effectively credit for new supply during that period, it's just that you're acknowledging what the high-water mark of the debt is. I'll leave my comments there.

ACTING CHAIR: If I could raise one potential further anomaly—and it might not be an anomaly, but it's something I reflected on when I read the judgement—and that is that there's a lag between when you issue the invoice and the supply of the goods and services. You look at these periods, be it 90 days or six months, and the initial invoices issued at the start of the period can relate to the supply of goods and services prior to the period commencing.

Prof. Wellard: That's right, and that also came up in the context of determining when the continuing business relationship ended. I think there was supply that had been made but not invoiced until after the relationship had ended, but because the invoice related to supply that was made at a time when there was a relationship it was taken to be inside the CVR netting arrangements. I think that point highlights the awkwardness of having a system where we're assessing transactions and trying to account for supply in a running account, but as well as that incorporating this starting point level of indebtedness concept to determine whether there's been a preference. The lag that you're referring to creates anomalies there as well. What the US approach has going for it is it just focuses very much on each payment and subsequent supplies. It focuses more on the transactions and what's happened rather than picking a starting point and comparing levels of indebtedness.

As I said earlier, whichever way you go with your starting point you're going to end up with anomalies. Now the CVR starts during the period. One way of getting around this anomaly might be to say, 'Well, let's look at the first invoice and we'll take the debts after the first invoice is struck as the starting point for the level of indebtedness comparison.' But that to me is fairly arbitrary as well. I think it's inconsistent with the High Court's judgement anyway because you're not really then taking into account the invoice from the first transaction—in fact, you'd be ignoring it. Your starting point would be the level of debt created by the first transaction but not acknowledging that transaction itself. It's a subtle point. The other way of illustrating it is, when we're looking at the starting balance here, which is now the law, we're not taking into account the invoices that have been struck and the ins and outs that have led to that balance. You're simply taking that balance as the starting point, so why would you do it any differently if the relationship starts during the period? That's why I think you keep coming back to a debt balance of zero, which is anomalous.

Ms MASCARENHAS: We've got the overview from a theoretical perspective, but I'm interested to hear your views, having worked in this area, on what you think the implications will be.

Mrs Erskine: Firstly, I like the decision, which may surprise you given that it's a decision that will make the amount of preferences that can be recovered and are commercially viable to pursue less. But if you leave that to one side, I've always felt that the peak indebtedness rule was arbitrary and unfair, and this decision rights something that had grown up over a period of time. I think, if we all put our hands on our hearts and said, 'Did we really understand where the peak indebtedness rule came from?' there'd not be many people who could actually do that. So, to me, it's a good decision. I hear what Mark says, and Mark is incredibly gifted and knowledgeable in relation to the law. I probably approach it from a different perspective. I think we need to be aware of the potential of the unintended consequences that flow from this judgement. When you're looking at your deliberations, I think if you look at it and say, 'What do you want to be or what do you think should be the end result?' and if as a consequence of that you work out the end result and then work back, there will be a formula that will flow from that.

Clearly, creditors need to be incentivised to continue to have a business relationship. There will be circumstances where creditors feel concerned about someone's ongoing viability, but they shouldn't be afraid to continue to supply that creditor, provided that in that relationship they get paid and the running account defence applies. The stopping of supply really does cause a company to fall over, so we need to encourage people to continue to do business.

One of the ways is to just say, 'Preferences are all too hard and we should abolish all of them.' That, in some respects, would make a lot of people very happy, and you will have seen that through some of the submissions that you've been getting. Some sectors think that they are terribly unfair and should be abolished. However, the reason I think that preferences should remain in the law is that otherwise you're going to have the consequence of the survival of the fittest. You're going to have the creditors that are savvy and have the resources, financially, to be able to engage the best lawyers in town, and they will get their money, and the other creditors who are less sophisticated and don't have the resources will be left behind. They won't get paid. The idea of the preferences is for a liquidator to be able to recover money into the pool of funds available for creditors and share it equally amongst them, recognising, of course, the priorities in section 556.

I think it was certainly a good decision of the High Court, and it provides clarity. Now I think we just need to sit back and digest that decision, and then, rather than think about the starting point, we should think about the end point, and with that as the equation—this is just an equation, at the end of the day—I think there will be an equation that we're all more comfortable with. But people need to be able to have confidence of continuing to supply.

In the issue that Mark's raised, that's where I have sympathy for the doctrine of ultimate effect, where you can see where you've got the money coming—there's supply of goods, they get paid, and then at the end of the day we do some sort of ready reference between the ultimate benefit or detriment suffered by the company. That to me is a really simple equation. With the creditor that has a one-off where they make the supply and get paid, you have to look at the circumstances around that. Is it just because they have a good that is a one-off supply and that's it, or is it because they've chosen not to supply? And then you've got all those other issues about knowledge of insolvency and things like that. In that instance, where they've chosen not to have a business relationship, they perhaps should be dealt with differently than the creditor who has prepared to continue to supply.

Ms MASCARENHAS: In my mind, what it's about is trying to create as much fairness as possible for the people who are seeking funds to be paid back to them. The thing that is tricky is for the law to foreshadow every single scenario. What it's about is maximising that fairness as much as possible. Do you feel like this judgement maximises that or do you think that we could achieve more fairness?

Mrs Erskine: I think the judgement goes a long way to achieving that by removing the peak indebtedness rule. As I said, it seemed illogical that I could just choose the highest point and maximise the claim that I could have against a creditor.

ACTING CHAIR: On that—and this is picking up on Mark's point from earlier, which I hadn't thought of before Mark raised it—you're not choosing the highest point. The highest point is the highest point. Do you understand what I mean?

Mrs Erskine: Yes. The highest point is the highest point, but the highest point—as in Mark's diagram—can be three months—

ACTING CHAIR: I understand that, but the highest point is objectively assessed. So, to some extent, it's not your election to choose the highest point. The peak indebtedness rule says you go to the highest point.

Ms MASCARENHAS: I guess the choice is around the equation that you use, so whether you use the peak indebtedness rule or whether the choice is another equation.

Mrs Erskine: Yes.

ACTING CHAIR: Correct, but it's not subjective from your perspective. The peak indebtedness is the peak indebtedness. Isn't that right?

Mrs Erskine: Yes, the peak indebtedness is the peak indebtedness. However, if you look at just the running account, where you take the opening amount and then you add in what they've supplied, subtract what their payments are, and what the balance is, then that's the preference you get. That's a lesser amount than what it is if you use the peak indebtedness rule.

ACTING CHAIR: I understand.

Mrs Erskine: To me, that's the fairest option.

Prof. Wellard: The point of the question I was trying to ask rhetorically before is: I do think reasonable minds can differ on just how you look at the situation I've put up there. is what we all understand in our own minds to be the effect of what's happened on that slide there. Is there a preference for 40 or is there a preference for 10? You can have different views on that question.

Ms MASCARENHAS: I'm wondering if Professor Anil Hargovan wants to add anything.

Prof. Hargovan: Perhaps I could launch into what I would like to say. Mark and I divided our class, and thank you Mark for getting to grips with all those technical aspects of the judgement. I would like to take a step back and address the big picture here. My remarks go to considerations that could be relevant for root and branch review, assuming such a review is to be undertaken. Unsurprisingly, there are competing policy issues here for consideration. Before we canvass the options available it's important to remember that in receiving a preference the preferred creditor is doing nothing wrong or improper. All preferences involve creditors getting what they're entitled to at law. That's a useful point to bear in mind.

When it comes to policy considerations, the key question and the issue here can be distilled down to: to what extent should we reflect the pari passu principle, which simply means equal treatment of creditors? This is set to be the foremost principle, if you like, in the law of insolvency around the world. But a lot of commentators have rightly pointed out that that is often a myth and that perhaps it should no longer be treated as a defining principle. I mention that because, depending on where one stands in their view on the role of the pari passu principle, that can really colour and influence your policy choices here. In terms of options available, Mark and I have identified three and that's not to say that perhaps there may be more. One option is to retain the status quo—that is with the abolition of the peak indebtedness rule—and to fine tune the existing law, and this is with reference to the US approach in the Bankruptcy Code as explained by Mark. I think the attraction with that approach is that it encourages creditors to continue to deal with the business and extend credit to them. And so if you believe that insolvency law is also all about corporate rescue and giving a company best chances then you would support that policy approach. We don't pretend to be experts on the US law, but, from my understanding anyway, it seems to eliminate this need to study the character of each transaction as we currently do in our law. In other words, the US approach seems to be forward looking rather backward and forward looking, which is what our current law expects us to do. We see some attraction in that approach. Another option—

Ms MASCARENHAS: Just very quickly on that point, I think one of the things that I'd like to see from an insolvency law perspective is efficiency in being able to apply the law. The simpler and fairer it is then the more money that can go back to creditors. Sorry. Continue.

Prof. Hargovan: Indeed. But to that point, and this is where it all becomes quite vexed, because the next policy option is to take a much stricter approach to practices and adopt what one commentator has labelled the 'automatic avoidance scheme.' What this approach does is that it says all transactions entered within a certain period of time would be set aside if they're classed as preferences. Obviously that approach has its advantages and disadvantages. It will provide a simpler scheme. There's no need to consider issues of insolvency. There's no need to consider defences, whether the defendant had a reason to suspect insolvency. It's likely to reduce the liquidator's investigation costs, the costs of gathering evidence. So under this very strict approach it will eliminate, if you like, the most technical and difficult problems of proving an unfair preference claim and it'll do away with the protective provisions that we currently have, including the running account exception. That's all on the plus side. But on the minus side you would have to ask: would that be fair to other creditors? So there's a question mark there.

Another policy option would be to consider a concession scheme where a minimum preference threshold must be satisfied before preference can be avoided. Currently, we don't have such a scheme in our law, but I should point out that in the 2022-23 budget of the previous government they did flag some reforms along these lines where I think it was proposed that amounts less than $30,000 or that were made more than three months prior to the company entering external administration would not be able to be clawed back. These are unenacted changes. I think there's some merit in giving this some active consideration. If one accepts that there should be this concession scheme, then I think that debate here is likely to turn on what amount the minimum should be. Is $30,000 too high or should it align with the statutory demand figure of $4,000 as I think mooted by ARITA. Is that figure then too low? So perhaps, again, we could look at the US position here with the Bankruptcy Code there. The current figure is US$7,575 and that figure is indexed and it's adjusted every three years. So I think it would be fair to say that if that policy option were to be considered the figure would lie somewhere between the

$4,000 and $30,000 that's been mooted. To conclude, it bears repeating that the underlying policy rationale for unfair preferences would need to be revisited to see if the current practice aligns with that particular goal.

ACTING CHAIR: I have just one quick question. And this maybe is the abolition of preferences, and I'm not stating a position in this regard. But the other view is, as you said, Professor Hargovan, in the cases we're talking about in this context there was no fault on the part of creditors. The other view is that the liquidator actually looks for areas where there are related party transactions or there's an intent to defraud creditors et cetera, as opposed to a creditor going about their ordinary commercial practices in the ordinary course of business. And the cards just fall where they fall, rather than trying to put Humpty Dumpty together again after the event, which is always going to be an extraordinarily complex and problematic process. There'll be inequities, even if unintended, so it's just too hard. What's your view in relation to that proposition?

Mrs Erskine: My view is that you run the risk, again, that the people who can pursue their debts will muscle the money and get paid, and the ones who can't or are late to the party will miss out; they won't get paid. Often the preference recovery provides a return to creditors that otherwise would not be there.

ACTING CHAIR: Perhaps I could ask a supplementary question in relation to that. If you've got a creditor who, say, has the resources to appoint a Mark Wellard or someone to defend their preference claim, as opposed to a creditor who doesn't, you're still going to have that position that a better resource creditor is going to be able to avoid the implications of this regime better than someone who doesn't have those resources, simply because you've got to make commercial decisions such as 'Do I pursue this?' or 'Do I go to court?' or 'Do I settle?' Isn't that the case?

Mrs Erskine: Yes, certainly the complexity of the law does lend itself to the fact that people who can be represented have better outcomes at times. However, most insolvency practitioners approach preferences on a commercial basis. For example, when I'm pursuing preferences I encourage people to come and have a conversation about a settlement early rather than run a High Court case.

ACTING CHAIR: Professor Wellard, you've got to get to the bottom of how this managed to go to the High Court, with the value involved. I'm intrigued! But anyway. Do you have any more questions, Zaneta?

Ms MASCARENHAS: The only thing I was going to say—because we're running out of time—was to ask whether everyone might want to have one or two minutes to make some concluding remarks.

ACTING CHAIR: To sum up, yes. Mark?

Prof. Wellard: I want to follow up on a couple of contributions from Mrs Erskine that I thought were really important. Firstly, I would wholeheartedly endorse the view that we need a preferences regime. The biggest risk of not having one is what Mrs Erskine pointed out—that the strongest and the most important, if you like, trading creditors will extract better positions for themselves and better outcomes for themselves on the point of liquidation. But the whole idea of preferences is to share the pain and have equality of outcomes.

The second point—and this goes to many of the really good comments Mrs Erskine made—is that whilst I'm pointing out anomalies I think that if we're going to go towards a review or a legislative rewrite then a solution and the factors that will have to come into the mix in arriving at the best calibrated preference laws will be very broad. It's not just about the peak debt rule. It's about the defences, it's about the time period and, importantly, as Mrs Erskine said, it's about creditor behaviour: what do we want? It's looking at the end point. What do we want out of our preference laws? What do we want continuing-business-relationship creditors to be doing vis-a-vis supporting financially distressed entities?

It's all well and good for people like me to be pointing out anomalies, but I completely agree that the solution is a much broader picture. That's why I think a root-and-branch review would put preferences as a prime subject matter.

ACTING CHAIR: Are there any concluding comments?

Mrs Erskine: I agree with what Mark just said then. I think preferences are important for the reasons that I've set out. Certainly some time should be taken to explore whether they can be made easier for all of us to get our head around. The discussions like we've had today are fine when we are all educated and capable people, but overlay that when you've got people who are novices to this area, and it's just baffling. So it's time to try and simplify an area that is overly complex. I think we also need to step back—and this applies to everything that you're going to be looking at and are looking at—and look at the public interest factor of insolvency. I'm very cognisant of the fact that, as an insolvency practitioner, I have not only duties to uphold the law but also a public interest duty, and that is that the law is there to protect those who may not be able to protect themselves. So, in terms of that issue about the 'survival of the fittest' argument that I've been raising today, it would certainly trouble me if preferences were completely done away with.

Prof. Hargovan: I have some cautionary remarks in terms of the root-and-branch review, if undertaken. I think one has to be careful about the automatic avoidance scheme. While it will achieve certain favourable outcomes, I think on balance it's perhaps too draconian. I think one should perhaps have a policy approach that doesn't encourage the supply of goods and services at credit. I wouldn't be surprised to see, when that review is undertaken, that the pari passu principle will be centre stage. One should remember that it's not a sacred cow. There are plenty of examples in law where there are exceptions to it. It is a weakened principle, and there is expert commentary that actually calls it 'a myth', so one should not I think let that colour the thinking.

Prof. Wellard: For my part, I would describe unfair preference laws in Australia as an area of law without any significant legislative amendment over the last decade that has become more complex with time. I think that's borne out by some of the cases that we've seen going to the High Court. In my view it's borne out by some of the anomalies that still remain. There might be some benefits in clarity, but I still think we have a series of laws—and this is a point which you could apply to insolvency law generally—which are very complex and not as efficient as they could be.

So for my part I've been very sympathetic in the last few years to looking at an automatic avoidance regime with a narrower period. Everyone is treated the same. You do have arbitrary and possibly draconian outcomes, as Professor Hargovan suggested—and he makes some really good points—but I'm of the mind now that we need to be trying to get rid of the unnecessary complexity and the cost that is arising from these laws, particularly with the money being spent on defences—creditors being infected with knowledge of insolvency when they're actually trying to help a company. Going back to that point: what do we want creditors to be doing in that situation? I think it's a big part of the solution and the processes in arriving at a series of laws which I think are simpler and fairer. You're always going to have arbitrary outcomes and you're always going to have creditors who are not happy with the preference regime, but I think we need to be looking at a system that is fairer, more efficient and less complex. Taking Professor Hargovan's point, we do need to be careful that we're not arriving at a draconian regime which is not going to produce what we want. If we do want creditors to be supporting companies in distress. perhaps an automatic avoidance regime is not the way to go. Again, given the complexity and the different competing considerations in play, it's a prime topic for a root-and-branch review.

ACTING CHAIR: Thank you. This was a private briefing. Given the quality of the evidence provided during this briefing, would you all be happy if we refer to your testimony as recorded in transcript in our reports? Are there any reservations? You don't have to give me an answer now, if you want to reflect on the question.

Mrs Erskine: I have no issues.

Prof. Wellard: I'm comfortable with that.

Prof. Hargovan: Yes, absolutely.

ACTING CHAIR: Thank you very much. That was very informative. That concludes today's proceedings. Thank you for coming to brief the committee today.

Committee adjourned at 09:10