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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
Canberra ACT

By email corporations.joint@aph.gov.au

Corporate Insolvency Law in Australia – submission of Mr Michael Murray and Adjunct Professor Rosalind Mason

We make this joint submission in response to the invitation to do so from the committee dated 10 October 2022.

Our submission relates to the duties of directors of insolvent companies and matters raised in 2014-2016 concerning the disparity in comparable obligations and duties between non-compliant bankrupts and non-compliant directors of insolvent companies. We argue that the difference is not supported by the reality of business conduct and that attention should be given to harmonising the law's regulatory approach to the individuals involved in personal and corporate insolvency.

As we will explain, a proposal was made to impose stronger restrictions on directors of insolvent companies who were not in compliance with their statutory obligations to provide a list of assets and liabilities – called a "report on company activities and property" (ROCAP) – and books and other records of the company. Those restrictions did not proceed and were in effect deferred. Our submission takes up those issues again and we also raise issues going beyond that past proposal.

In part our submission is prompted by the severe restrictions imposed on persons who become bankrupt, for 3 or more years; and by the fact that bankruptcy and corporate liquidation are examined separately, by two different departments, leading to unnecessarily different policies being pursued. This also adversely impacts the regulation of trustees and liquidators.

Personal and corporate liabilities

The law's treatment of the directors and shareholders in the liquidation of a company is markedly more sympathetic than its treatment of an individual subject to bankruptcy. This is even more apparent in the case of a small business that fails in Australia's current circumstances where the respective laws are drafted and debated in different ways. Harmonising the law's regulatory approach to the individuals involved in personal and corporate insolvency is necessary given the realities of many small businesses, where, though operated through a company, there is an intertwining of company and personal debt of the owners, through personal guarantees, tax liabilities and the owners' use of their personal funds to support the business.

Thus, it has been said that

> "personal insolvency regimes are often more relevant for entrepreneurs and small businesses. Indeed, the corporate vs non-corporate distinction in assets and liabilities is often blurred for small firms, either because lenders require personal guarantees or security – e.g. a second mortgage on the owner's home – or because prior to incorporating and obtaining limited liability protection, entrepreneurs typically use personal finances …".[1]

US studies have examined the extent to which personal difficulties cause corporate business bankruptcies,[2] for reasons including the owner's matrimonial property disputes; personal and family health problems, including illness or death of key personnel; and theft and criminal loss. Even the concept of consumer debt is not sound when the business provides the financial support for the owner and their family.

Australian Financial Security Authority (AFSA), the personal insolvency regulator, records "business bankruptcies", as defined,[3] in its regular statistics. These are usually within the range of 25-40%. In September 2022, 34.9% of bankruptcies were business related, with the highest proportion in construction. The statistics do not separate those arising from company liabilities.

The Australian Bureau of Statistics (ABS) figures show that Australian businesses comprise about equal numbers of companies and individual or partnership traders.[4] The vast majority of these are micro to small to medium enterprises (MSMEs). Many of those companies are sole director shareholder structures. Australia's corporate insolvency regime addresses the company's liabilities but it specifically does not fully address the owner's personal debts or guarantees of the company's liabilities.[5] As much as it does in some cases is defer their enforcement.

Perceptions of debt

In the context of what became the Insolvency Law Reform Act 2016 (ILRA 2016), the government had considered evening up the responsibilities of entrepreneurs and directors by way of imposing some level of restriction on directors who failed to provide what was then a report as to affairs (RATA) and the company's books and other records, comparable with consequences imposed on non-compliant bankrupts. These reforms were however rejected as

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[1] *Design Of Insolvency Regimes Across Countries* 2018 OECD Economics Department Working Papers No. 1504 by Müge Adalet McGowan and Dan Andrews, citing Berkowitz, and White, "Bankruptcy and Small Firms' Access to Credit", (2004) 35 RAND Journal of Economics; Cumming, "Measuring the Effect of Bankruptcy Laws on Entrepreneurship across Countries", (2012) 16 Journal of Entrepreneurial Finance).

[2] Warren and Westbrook "Financial Characteristics of Businesses in Bankruptcy" (1999) 73 Am Bankr LJ 499, 560–561. See also *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia*, a joint project by the International Insolvency Institute and the Asian Business Law Institute, 2022, Features of MSEs, pp 14-16. < https://abli.asia/ >

[3] AFSA defines "business-related bankruptcy" as "Where an individual's bankruptcy is directly related to his or her proprietary interest in a business." < https://www.afsa.gov.au/glossary#statistics >

[4] ABS August 2022.

[5] ASBFEO's Submission to the Productivity Commission's 2022 Inquiry into Australia's Productivity Performance called for "Improvements … to insolvency processes for small and family businesses." < https://www.asbfeo.gov.au/sites/default/files/2022-04/20220404%20BB%20to%20Productivity%20Commission.pdf>

being "unjustifiably harsh" and all the government did was to arrange to have the RATA improved, the then existing version being said to unduly confuse directors.[6]

But the government did undertake to review the law, in 5 years after it commenced, that is, in 2022.[7] This inquiry offers the forum for this to occur.

Detail

From a legal perspective, how the business is legally constituted will be relevant – generally either operated by the individual owner through a company as shareholder and director ("director") or operated by the business owner as a sole trader[8] ("sole trader"). In the event that the business fails, the insolvency consequences for each individual are quite different.

There is the legal reality that a company is a separate entity from the owner; and it is the company, and not the owner, that has incurred excessive debt and is put through the liquidation process. By comparison, it is the sole trader who incurs debt and becomes insolvent and goes bankrupt.

Obligations to assist the liquidator or trustee

When a business fails and an insolvency practitioner (IP) is appointed, there is a serious obligation imposed on those running the business to assist the IP with information and documents. The IP is appointed as an independent person with no real background knowledge of the business but with a need to quickly acquire that knowledge so as to be able to locate and gather in assets, contact creditors and as necessary take control of the business.

The director of a company wound up by court order is required to provide a completed ROCAP to the liquidator and other information sought by the liquidator, generally, within 10 business days of the order: s 475. The liquidator is entitled to access to the company's books: s 477(3). Directors and others may be required to deliver up to the liquidator any money, property of books of the company: s 483.

Similarly, on a court sequestration (bankruptcy) order being made, a bankrupt must deliver a completed statement of affairs within 14 days: s 54 *Bankruptcy Act*; the 3 year period of bankruptcy commences only when that is filed: s 149(2). There are comparable but higher obligations of bankrupts to assist the trustee - to deliver books and attend meetings with the trustee or meetings of creditors - non-compliance allows the trustee to lodge an objection to discharge under s 149D, extending the 3 year period of bankruptcy up to 8 years.

[6] Explanatory Memorandum, Insolvency Law Reform Bill 2015 (EM ILRB 2015) , paragraphs 9.354 – 9.376.
[7] EM ILRB 2015, paragraphs 9.377, 9.381.
[8] The business may also be operated by individuals in a partnership, however for simplicity, we use the term "sole trader" throughout.

While both sole traders and directors have responsibilities to assist the IP appointed to their own affairs or their company's,[9] the means of enforcement of those tasks and the consequences of non-compliance are markedly different. Directors suffer none of the default consequences imposed on non-compliant bankrupts, despite the adverse consequences of lack of assistance for the IP being the same. This is so even though there is nothing particularly different between a bankruptcy and a liquidation that makes it of greater urgency or importance.

The primary responsibility of the directors, in the case of court appointed IPs, is to provide a ROCAP for their company. A director's delay or refusal to provide that list is a serious matter and is understandably an offence, which may be prosecuted. But there is no default consequence for directors comparable to the automatic extension of the person's bankruptcy. Nor is there any process comparable to an objection to discharge for failure to provide company books.

The question we ask is whether that disparity between directors and sole traders is fair and effective. Is bankruptcy too severe or is corporate insolvency too lenient? We put aside for the moment the numerous other impositions of bankruptcy, and the length of time that they continue.

Attempts at law reform

We have referred to an attempt to "even up" the responsibilities.

In the 2015 Explanatory Memorandum (EM) accompanying the Insolvency Law Reform Bill at [9.325], the government broadly acknowledged that the directors may be uncooperative in completing and lodging a then RATA which was required to be provided on behalf of the company at commencement of the liquidation.[10]

One option proposed [Option 6.3] was to allow ASIC to administratively suspend a director for failure to provide a RATA or books of the company.[11] On the likely net benefit of this option, the EM said [9.341],

> "this option would seek to achieve a similar outcome as that currently provided for in personal insolvency [referring to section 77CA of the Bankruptcy Act; with an offence provision for non-compliance in section 267B] with the regulator assisting insolvency practitioners to obtain important information regarding the company under administration, which will assist in the efficient completion of the winding up".

[9] There is a statutory obligation of a director to prepare a statement of the company's assets and liabilities and to deliver up company property and books to the liquidator and otherwise assist the liquidator. Section 475 is an offence provision on a strict liability basis, with a penalty of up to 50 penalty units and/or 6 months imprisonment. That is comparable with the 50 penalty units imposed by s 54 of the Bankruptcy Act on a strict liability basis.
[10] See EM ILRB 2015 at [9.325].
[11] See EM ILRB 2015 at [6.331] – [9.334].

The measure was also seen [9.342] as assisting

> "in addressing phoenix activity in limited circumstances where a director has transferred assets out of their initial company (OldCo) into a new company (NewCo), placed OldCo into liquidation, is refusing to assist the corporate insolvency practitioner in completing the winding up of OldCo and is managing NewCo".

However, this proposed regime was said in submissions by director groups to be "unjustifiably harsh" [9.369] for a range of reasons:

- in imposing a penalty that was not proportionate to the misconduct;
- in failing to provide appropriate court oversight to the power for ASIC to disqualify directors;
- in providing insufficient procedural fairness;
- in inappropriately balancing the power of ASIC with the rights of the individual directors; and
- in failing to recognise the significance of disqualifying directors. [9.343]

It was also submitted that the then RATA form was confusing; and this might well have explained many instances of director non-compliance.

It was only in response to the last issue that the government acted, by way of having the then RATA form reviewed and redrafted. The RATA form had in fact not been altered in several decades and there was some sense in attending to what may have been an exacerbating issue in director compliance rather than simply passing a stronger law.

That review proceeded and a new form – the ROCAP replacing the RATA in 2018 – was the result.[12] A subsequent review resulted in Version 2 of the ROCAP operative from 1 August 2022. Whether director compliance has improved with the replacement of the RATA by the ROCAP is not stated. Irrespective, the government said in its explanatory memorandum to the ILRB 2015 that there should be a review of this change and other personal and corporate insolvency reforms under the ILRA.[13]

The government's response, to simplify the form, although with some validity, was nevertheless a limited response to a larger issue about the need for directors to comply and assist liquidators. The need to provide liquidators with the company's financial and other records is another compliance requirement where, unlike the previous RATA, there is no lack of clarity about the obligation imposed.

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[12] ASIC said it intended "revising the ROCAP periodically, with a Version 2 anticipated following industry feedback after a period of use. … A further version of the ROCAP may coincide with any possible law reform that will facilitate lodgement of Part B with ASIC on a confidential basis". Report on company activities and property (ROCAP) | ASIC - Australian Securities and Investments Commission. Revised Report on company activities and property (ROCAP) 2022: https://asic.gov.au/for-finance-professionals/registered-liquidators/your-ongoing-obligations-as-a-registered-liquidator/report-on-company-activities-and-property-rocap/

[13] EM ILRB 2015 at [9.381].

We suggest that any review should not be confined simply to whether the new ROCAP has produced positive results. It should be reviewed in the context of the obligations of individuals in insolvency generally, small business insolvency in particular, and the need for consistency of approach.

We realise that this inquiry by the Parliamentary Joint Committee on Corporations and Financial Services is limited to corporate insolvency law. This would be because of the current unsatisfactory, in our view, bifurcation on Australia's insolvency law between the Treasurer and the Attorney-General. This separation is not based upon policy but on a constitutional quirk at federation based on a limited view of the federal power in respect of corporations, since discounted. We recommend that personal insolvency policy be moved to Treasury, to sit alongside corporate insolvency and ASIC, the ATO and the ASBFEO, each of which is closely involved with small business.

The restriction of the current inquiry to corporate insolvency law, particularly in the context of the significance of small business to the Australian economy highlights the absurdity of this bifurcation.[14] It also highlights whether there will be a similar review of the personal insolvency components of the ILRA which were also to be undertaken 5 years after their commencement.

Relevance of a deeper issue

We raise but do not address here what we suggest are some deeper reasons for what we see as a disparity in cultural perceptions as to both corporate and personal debts, and business and consumer debts. That is, there is a difference in community perception between personal and corporate debts leading to the more severe way the law treats a personal insolvent compared with a director of an insolvent company, in both cases where we might assume, for the sake of argument, their standards of commercial conduct have been the same.

Overall, we suggest that a personal bankruptcy is seen as resulting from an individual's lack of personal control, whereas a liquidation of one's company is a distant and objective event detached from the individual director and caused by market conditions and risk.

Government perceptions

It remains to point out that the government itself adopts or at least accepts this undue separation in the way the law is framed. It refers to its 2021 (corporate) small business restructuring (SBR) reforms as addressing the need to "meet the needs of small business and to support increased productivity and innovation by reducing the complexity and costs in insolvency processes. Further, the reforms are aimed at achieving greater economic dynamism and ultimately helping more small businesses to survive".[15]

[14] We raised this in more detail in Moffatt P, Mason R and Murray M, *Improving the regulation of insolvency practitioners in the UK and Australia. Would a single regulator help?* Nottingham Insolvency and Business Law e-Journal, 10, pp. 1-63. ISSN 2053-1648. This was in the context of a comparison between the regulation of IPs in the UK and Australia. < http://irep.ntu.ac.uk/id/eprint/46829/>

[15] Explanatory Memorandum, Corporations Amendment (Corporate Insolvency Reforms) Bill 2020.

There were no comparable supportive words from the Attorney-General in relation to the many sole traders impacted by COVID-19; in fact there have been no insolvency reforms addressing their need for support. In response to a January 2021 discussion paper, following a 2018 attempt at reform, the Attorney-General's Department reported in January 2022 on its proposals,[16] saying that while many stakeholders supported reform, some were "concerned that a default period of one year will be abused by rogue, reckless and repeat bankrupts" and it went on to present an array of proposals to meet those concerns.

That seems to assume there are no rogue, reckless and repeat directors. The introduction of Director-Identification Numbers would belie this.

The timing was also interesting. The SBR corporate reforms were introduced into law with what was said to be undue haste, with submissions open during the limited period of 7–12 October 2020 and the law commencing 1 January 2021. The bankruptcy reforms were first proposed in 2015.[17]

Universal obligations

For the purposes of offering some universal approach across insolvency law, we suggest some universal set of obligations in both bankruptcy and liquidations that are aimed at assisting the trustee or liquidator in managing the insolvent estate, with comparable consequences for non-compliance.

These obligations are broadly the completion of statements of assets and liabilities and giving early assistance to the trustee or liquidator by way of delivering books, giving information, identifying assets etc; failing which the person is restricted in pursuing defined activity.[18] These obligations of the debtor are accepted as being necessary, however much another goal of insolvency law is to release the individual debtor and company owner and allow their fresh start.[19]

One enforcement option would be the placing of restrictions on existing directorships of the director or preventing new directorships. Previous debates about the "harshness" of this approach need to be seen in the context we suggest. The director ID will significantly increase any enforcement options.

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[16] Bankruptcy system - options paper, January 2022 < https://consultations.ag.gov.au/legal-system/bankruptcy-system-possible-reforms/ >

[17] National Innovation and Science Agenda, November 2015 National Innovation and Science Agenda report | Department of Industry, Science and Resources

[18] UNCITRAL's Legislative Guide on Insolvency Law lists these debtor obligations as including to cooperate with and assist the insolvency representative, to provide accurate, reliable and complete information, including as to prior transactions, on-going proceedings, and so on. Standardized information forms that set out the specific information required" will assist. It acknowledges there should be sanctions, in the case of a company for example, "any person who generally might be described as being in control of the debtor, including directors and management". (Part 5 Insolvency Law of micro and small enterprises (advance copy) < https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/msms_insolvency_ebook.pdf >.

[19] Nicola Howell, "The Fresh Start Goal of the *Bankruptcy Act*: Giving a Temporary Reprieve or Facilitating Debtor Rehabilitation" (2014) 14(3) *QUT Law Review* 29. < https://lr.law.qut.edu.au/article/view/553 html >

Broader reform

Insolvency law's separation into personal and corporate debts and assets belies a commercial reality, that small business is based on companies which offer a complete separation from the owners' own affairs. That is not the reality for the reasons we have offered.

While this is a call for broader reform than focusing on the obligations of individuals, it is one that should be pursued, or at least acknowledged. The *World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes*, 2021[20] and the *UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises* 2022[21] both refer to the need for a simplified insolvency system for small business by which, for example, "all personal and business debts of a natural person should be included in simplified insolvency proceedings"(C19.1) and "should address, including through procedural consolidation or coordination of linked proceedings, the treatment of personal guarantees provided for business needs of the MSE debtor" (C19.8).[22] Likewise, the recently launched International Insolvency Institute – Asian Business Law Institute, *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia*, recommends that "Asian jurisdictions should adopt simplified insolvency rules for MSEs, and ideally adopt simplified insolvency processes." [23]

While it would be difficult to unwind the settled separate approaches of insolvency law, it would be necessary for any 'holistic' insolvency law reform.

A "soft law" pragmatic alternative would be to move personal insolvency policy and AFSA to Treasury, which would assist in comparing and aligning personal and corporate insolvency law in regulating debtor and director conduct, and on-going. A central government agency, that is, Treasury, is needed for the desired holistic approach to the issue. The current bifurcation is a reason this submission needed to be made.

M Murray

Michael Murray
Murrays Legal

R Mason

Dr Rosalind Mason
Adjunct Professor of Law, Queensland University of Technology

[20] Principles for Effective Insolvency and Creditor/Debtor Regimes, 2021 Edition (worldbank.org)
[21] UNCITRAL Legislative Guide on Insolvency Law for Micro- and Small Enterprises
[22] Referring to the World Bank Principles.
[23] *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia* 2022, Principle 1. The Guide includes Australia and New Zealand in Asia. < https://abli.asia/ >.